

## **NCUA REGULATION/GUIDANCE RELATED TO EVALUATING THIRD PARTY PROVIDERS**

1. NCUA RR, Part 748, App A -  
([http://www.ncua.gov/RegulationsOpinionsLaws/rules\\_and\\_regs/NCUA\\_RR\\_Complete\\_2.pdf](http://www.ncua.gov/RegulationsOpinionsLaws/rules_and_regs/NCUA_RR_Complete_2.pdf))
2. NCUA RR, Part 701.21(h)(1) –  
<http://www.ncua.gov/RegulationsOpinionsLaws/RecentFinalRegs/F-701-741.pdf>)
3. NCUA RR, Part 741.203(c) –  
(<http://www.ncua.gov/RegulationsOpinionsLaws/RecentFinalRegs/F-701-741.pdf>)
4. NCUA LTCU 01-CU-20, Due Diligence Over Third Party Service Providers –  
(<http://www.ncua.gov/letters/2001/01-CU-20.pdf>)
5. NCUA LTCU 04-CU-13, Specialized Lending Activities –  
(<http://www.ncua.gov/letters/2004/04-CU-13.pdf>)
6. NCUA Risk Alert 05-Risk-01, Specialized Lending Activities–3rd Party Subprime Indirect Lending and Participations –  
(<http://www.ncua.gov/RiskAlert/2005/05-RISK-01.pdf>)
7. AIRES Questionnaire Workbook – Loan Outsourced Lending Relationships –  
<http://www.ncua.gov/CreditUnionResources/aires/aires.html>)
8. AIRES IT Questionnaire Workbook – IT Vendor Oversight –  
(<http://www.ncua.gov/IST/ExaminationResources.htm>)
- 9.

# **NCUA LETTER TO CREDIT UNIONS**

**NATIONAL CREDIT UNION ADMINISTRATION  
1775 Duke Street, Alexandria, VA 22314**

**DATE: DECEMBER 2007 LETTER NO. : 07-CU-12**

**TO: Federally Insured Credit Unions**

**SUBJ: CAMEL Rating System**

**ENCL: (1) Appendix A - NCUA's CAMEL Rating System (CAMEL)**

Dear Board of Directors:

The National Credit Union Administration (NCUA) is modifying the CAMEL Rating System (CAMEL) by eliminating the CAMEL Matrix (Matrix). The Matrix measured financial ratio results against benchmarks for three CAMEL areas: Capital Adequacy, Asset Quality, and Earnings. Appendix A is updated to eliminate the Matrix and focus CAMEL evaluation on risk consistent with NCUA's Risk Focused Examination Program (RFE)<sup>1</sup>. This change will be effective with NCUA examination and supervision contacts with December 31, 2007, effective dates and thereafter.

The following information explains the background of CAMEL, the basis for eliminating the Matrix, and NCUA's plan to implement this change.

## **CAMEL Background:**

CAMEL is based on the Federal Financial Institutions Examination Council's (FFIEC)<sup>2</sup> Uniform Financial Institutions Rating System (UFIRS) commonly referred to as CAMEL<sup>3</sup>. The FFIEC developed UFIRS in 1979 to assess risk on a system wide basis. NCUA adopted CAMEL in October 1987. NCUA

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<sup>1</sup> NCUA Letter to Federal Credit Unions No: 02-FCU-09 Risk-Focused Examination Program, May 2002.

<sup>2</sup> The Federal Financial Institutions Examination Council (FFIEC) was established on March 10, 1979, pursuant to title X of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA), Public Law 95-630. The council is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions and to make recommendations to promote uniformity in the supervision of financial institutions.

<sup>3</sup> See 61 Federal Register 67021 (12/19/1996) – Federal Financial Institutions Examination Council-Uniform Financial Institutions Rating System.

examiners evaluate CAMEL components and overall codes based on Appendix A. CAMEL is an internal rating system used for evaluating the soundness of credit unions on a uniform basis, the degree of risk to the National Credit Union Share Insurance Fund (NCUSIF), and for identifying those institutions requiring special supervisory attention or concern. NCUA periodically modifies CAMEL to respond to changes in the financial services industry and supervisory policies and procedures. The previous CAMEL Rating System update was published in Letter to Credit Unions No. 03-CU-04, dated March 2003.

***Matrix Background*** - In 1979, NCUA began rating credit unions based on UFIRS rating definitions using a system called Early Warning System (EWS). EWS assigned an overall rating of 1 to 4. NCUA's intent in adopting the Matrix was to ensure examiner consistency transitioning from a single rating EWS system to the CAMEL Rating System in 1987. After CAMEL's implementation, NCUA modified the Matrix numerous times to capture changes in credit union operations and financial markets. In 1995, the Matrix became an **optional** examiner tool when NCUA adopted Flexible Scope Examinations. The requirement examiners use the Matrix was eliminated because financial ratios alone can be a lagging indicator of changing risk. Successful performance requires credit unions measure, monitor, and control risk relative to strategic plans and goals rather than meeting predetermined ratio benchmarks.

***NCUA's Risk Focused Examinations*** - RFEs introduced in 2002 focus examiner resources on risk using a forward looking perspective rather than a comparison of performance against benchmarks. Examiners look beyond current financial conditions and evaluate management's ability to recognize and adapt to changing economic conditions, competitive environments, and risk profiles. Examiners determine the significance of ratios, trends, projections, and interrelationships using seven risk categories (Credit Risk, Interest Rate Risk, Liquidity Risk, Strategic Risk, Compliance Risk, Reputation Risk, and Transaction Risk).

***CAMEL Interrelationship with the Risk Focused Examination*** - In RFEs, the seven risk categories are assessed a level (high, moderate, or low) reflecting the current and prospective risk to the credit union. Material risk identified in a risk category is reflected in the appropriate CAMEL component code(s) and overall CAMEL code. CAMEL quantifies the impact material risk has on the credit union's soundness and identifies the level of NCUA supervision required.

#### **Basis for Eliminating Matrix:**

NCUA is concerned some credit unions may target and measure performance against the Matrix rather than focus on broader risk management. Targeting CAMEL benchmarks in the Matrix can lead to unsafe and unsound goals and may lead to poor business decisions. For example:

- The Matrix benchmark for a “1” Capital Adequacy component rating is a net worth to total assets ratio equal to or exceeding seven percent. In some cases, if risk is high and unmitigated, targeting the “1” benchmark may result in insufficient net worth relative to risk. The “1” rating benchmark may create a false sense of security when net worth should be higher. The component definition for capital adequacy targets required statutory net worth for a CAMEL “1” rating. Individual credit unions may need additional net worth above regulatory requirements based on the level of risk pursued.
- Targeting delinquency levels to a Matrix “1” rating under asset quality may limit risk based lending options and service to members.
- Striving for a “1” benchmark rating for earnings may reduce service to members, promote excessive fee structures, or encourage excessive risk taking to generate higher returns.

Sound risk management requires officials establish and measure the credit union’s and management’s performance based on internal goals and objectives rather than Matrix benchmarks.

***Impact of Eliminating the Matrix*** - Eliminating the Matrix ensures examiners focus on risk. This revision promotes and complements risk management practices in credit unions by directing attention to the seven risk categories.

The Matrix maintained an element of controversy even after it became an optional examiner tool. All credit unions do not have identical risk profiles or business models. The Matrix applied static ratio benchmarks to every credit union. Some credit unions requested NCUA eliminate the Matrix while others were comfortable with a consistent Matrix approach. Over time, NCUA revised and eliminated Matrix ratios and adjusted the benchmark parameters, but the Matrix’s value is limited as the financial services industry changes. In some cases, targeting the Matrix may contribute to a credit union pursuing unsafe and unsound practices or less than advantageous strategic goals.

By eliminating the Matrix, focus will be on evaluating a credit union’s goals and determining strategic plans are realistic, tailored to the credit union’s unique needs, reflective of the current economic environment, and ultimately, in the best interest of the membership. Eliminating the Matrix fosters discussion on risk management issues and focuses analysis on management’s evaluation and control of risk rather than predetermined benchmark performance.

***Examiner Consistency without a Matrix*** - For examination and supervision contacts with December 31, 2007, effective dates and thereafter, examiners will continue the RFE practice to assign CAMEL component and composite codes using Appendix A. Appendix A is revised to eliminate the Matrix as an optional

examiner analysis tool. Examiners will assign the “C”, “A”, and “E” component ratings without a matrix following the approach currently used for assigning the “M” and “L”. The RFE practice to disclose CAMEL component ratings and the overall rating in the Examination Report Overview will continue. When a CAMEL component or composite rating changes, examiners will inform management. Disclosing ratings facilitate understanding of NCUA’s assessment of the credit union’s overall operation.

***Oversight of CAMEL Ratings Assigned*** - CAMEL ratings receive scrutiny both internal and external to NCUA. NCUA receives an annual audit by an independent auditing firm and is subject to scrutiny from other government entities. Internally, NCUA’s risk management practices and quality control processes monitor CAMEL component ratings and overall ratings.

### **Implementation Plan:**

NCUA staff that use CAMEL will receive training about this CAMEL update prior to implementation. This same training will be made available to state supervisory authority staff that needs to be aware of NCUA’s CAMEL Rating System. NCUA will continue to communicate with credit unions to ensure a thorough understanding of CAMEL's purpose and this update. In anticipation of this CAMEL update, officials are also encouraged to review the following recent NCUA resources related to CAMEL:

- NCUA Letter to Federal Credit Unions No. 06-FCU-04 Supervisory Letter-Evaluation of Earnings
- NCUA Letter to Federal Credit Unions No. 05-CU-01 Supervising Community Development Credit Unions – Examiner Guidance White Paper

This Letter supersedes Letter to Credit Unions No. 03-CU-04. Please direct any questions you may have to your examiner, supervisory examiner, regional director, or state regulator. Per NCUA Interpretive Ruling and Policy Statement

(IRPS) No. 95-1, credit unions may also discuss CAMEL disputes with NCUA's Supervisory Review Committee.

Sincerely,

/s/

JoAnn M. Johnson  
Chairman

Enclosure

## **APPENDIX A**

### **NCUA'S CAMEL RATING SYSTEM (CAMEL)<sup>1</sup>**

The CAMEL rating system is based upon an evaluation of five critical elements of a credit union's operations: **C**apital Adequacy, **A**sset Quality, **M**anagement, **E**arnings, and **L**iquidity/Asset-Liability Management. CAMEL is designed to take into account and reflect all significant financial, operational, and management factors examiners assess in their evaluation of a credit union's performance and risk profile.

Examiners rate credit unions based on their assessment of the individual credit union rather than against peer averages. Peer averages do not necessarily reflect credit unions are operated in a safe and sound manner. The CAMEL ratings should reflect the condition of the credit union regardless of peer performance. Examiners are expected to use their professional judgment and consider both qualitative and quantitative factors when analyzing a credit union's performance. Since numbers are often lagging indicators of a credit union's condition, the examiner must also conduct a qualitative analysis of current and projected operations when assigning CAMEL ratings.

Part of the examiner's qualitative analysis includes an assessment of the credit union's risk management program. In Risk Focused Examinations (RFEs), examiners assess the amount and direction of risk exposure in seven categories: Credit, Interest Rate, Liquidity, Transaction, Compliance, Reputation, and Strategic (seven risk categories) and determine how the nature and extent of these risks affect one or more CAMEL components.

Although the CAMEL composite rating should normally bear a close relationship to the component ratings, the examiner does not derive the composite rating solely by computing an arithmetic average of the component ratings. Examiners consider the interrelationships between CAMEL components when assigning the overall rating. Some of the evaluation factors are reiterated under one or more of the components to reinforce the interrelationships between components. The following two sections contain the component and composite ratings.

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<sup>1</sup> See 61 Federal Register 67021 (12/19/1996)-Federal Financial Institutions Examination Council-Uniform Financial Institutions Rating System.

## **CAMEL COMPOSITE RATINGS**

**Rating 1** - Credit unions in this group are sound in every respect and generally have components rated 1 and 2. Any weaknesses are minor and can be handled in a routine manner by the board of directors and management. These credit unions are the most capable of withstanding unpredictable business conditions and are resistant to outside influences such as economic instability in their trade area. These credit unions are in substantial compliance with laws and regulations. As a result, they exhibit sound performance and risk management practices relative to the credit union's size, complexity, and risk profile, and give no cause for supervisory concern.

**Rating 2** – Credit unions in this group are fundamentally sound. For a credit union to receive this rating, generally no component rating should be more severe than a 3. Only moderate weaknesses are present and are well within the board of directors' and management's capabilities and willingness to correct. These credit unions are stable and are capable of withstanding business fluctuations. These credit unions are in substantial compliance with laws and regulations. Overall risk management practices are satisfactory relative to the credit union's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

**Rating 3** - Credit unions in this group exhibit some degree of supervisory concern in one or more of the component areas. These credit unions exhibit a combination of weaknesses that may range from moderate to severe; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Credit unions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those rated a composite 1 or 2. Additionally, these credit unions may be in significant noncompliance with laws and regulations. Risk management practices may be less than satisfactory relative to the credit union's size, complexity, and risk profile. These credit unions require more than normal supervision which may include enforcement actions. Failure appears unlikely, however, given overall strength and financial capacity of these credit unions.

**Rating 4** - Credit unions in this group generally exhibit unsafe and unsound practices or conditions. There are serious financial or managerial deficiencies that result in unsatisfactory performance. The problems range from severe to critically deficient. The weaknesses and problems are not being satisfactorily addressed or resolved by the board of directors and management. Credit unions in this group generally are not capable of withstanding business fluctuations.



There may be significant noncompliance with laws and regulations. Risk management practices are generally unacceptable relative to the credit union's size, complexity, and risk profile. Close supervisory attention is required, which means, in most cases, enforcement action is necessary to address the problems. Credit unions in the group pose a risk to the National Credit Union Share Insurance Fund (NCUSIF). Failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.

**Rating 5** – Credit unions in this group exhibit extremely unsafe and unsound practices and conditions; exhibit a critically deficient performance; often contain inadequate risk management practices relative to the credit union's size, complexity, and risk profile; and are of the greatest supervisory concern. The volume and severity of problems are beyond management's ability or willingness to control or correct. Immediate outside financial or other assistance is needed in order for the credit union to be viable. Ongoing supervisory attention is necessary. Credit unions in this group pose a significant risk to the NCUSIF and failure is highly probable.

## **CAMEL COMPONENT RATINGS**

### **CAPITAL**

A credit union is expected to maintain capital commensurate with the nature and extent of risk to the institution and the ability of management to identify, measure, monitor, and control these risks. The effect of credit, market, and other risk on the credit union's financial condition is considered when evaluating capital adequacy. The types and quantity of risk inherent in a credit union's activities will determine the extent to which it may be necessary to maintain capital to properly reflect the potentially adverse consequences these risks may have on the institution's capital. Regulatory capital requirements are minimum levels and separate and distinct from a credit union's need to maintain capital commensurate with the level of risk inherent in operations. A credit union's capital adequacy is based upon, but not limited to, an assessment of the following evaluation factors. The order of these factors does not signify a level of importance.

- ❑ Capital level and quality of capital;
- ❑ Overall financial condition;
- ❑ The ability of management to address emerging needs for additional capital;
- ❑ Compliance with risk-based net worth requirements;
- ❑ Composition of capital;
- ❑ Interest and dividend policies and practices;
- ❑ Quality, type, liquidity, and diversification of assets, with particular reference to classified assets;
- ❑ Loan and investment concentrations;
- ❑ Balance sheet composition including the nature and amount of market risk, concentration risk, and risk associated with nontraditional activities;
- ❑ Growth plans and past experience managing growth;
- ❑ Volume and risk characteristics of new business initiatives;
- ❑ Ability of management to control and monitor risk;
- ❑ Earnings quality and composition;
- ❑ Liquidity and asset-liability management;
- ❑ Extent of contingent liabilities and existence of pending litigation;
- ❑ Field of membership; and
- ❑ Economic environment.

## **RATINGS**

A capital adequacy rating of 1 indicates sound capital relative to the credit union's current and prospective risk profile.

A rating of 2 indicates satisfactory capital relative to the credit union's current and prospective risk profile.

A capital adequacy rating of 3 reflects less than satisfactory capital that does not fully support the credit union's current and prospective risk profile. The rating indicates a need for improvement.

A capital adequacy rating of 4 indicates deficient capital. In light of the credit union's current and prospective risk profile, viability of the credit union may be threatened. Financial support from outsiders may be required.

A rating of 5 indicates critically deficient capital in light of the credit union's current and prospective risk profile such that the credit union's viability is threatened. Immediate assistance from external sources or financial support is required.

## **ASSET QUALITY**

The asset quality rating reflects the quantity of existing and potential credit risk associated with the loan and investment portfolios, other real estate owned (OREO), and other assets, as well as off-balance sheet transactions. The ability of management to identify, measure, monitor, and control credit risk is also reflected here. The evaluation of asset quality should consider the adequacy of the allowance for loan and lease losses and weigh the exposure to counterparty issuer or borrower default under actual or implied contractual agreements. All other risks that may affect the value or marketability of a credit union's assets, including but not limited to the seven risk categories, should be considered.

A credit union's asset quality is based upon, but not limited to, an assessment of the following evaluation factors. The order of these factors does not signify a level of importance.

- ❑ The quality of loan underwriting, policies, procedures, and practices;
- ❑ The internal controls and due diligence procedures in place to review new loan programs, high concentrations, and changes in underwriting procedures and practices of existing programs;

- ❑ The level, distribution, and severity of classified assets;
- ❑ The adequacy of the allowance for loan and lease losses and other asset valuation reserves;
- ❑ The level and composition of nonaccrual and restructured assets;
- ❑ The ability of management to properly administer its assets, including the timely identification and collection of problem assets;
- ❑ The existence of significant growth trends indicating erosion or improvement in asset quality;
- ❑ The existence of loan concentrations that present undue risk to the credit union;
- ❑ The appropriateness of investment policies and practices;
- ❑ The investment risk factors when compared to capital and earnings structure; and
- ❑ The effect of fair (market) value of investments compared to book value of investments.

## **RATINGS**

A rating of 1 indicates sound asset quality and credit administration practices. Identified weaknesses are minor in nature and risk exposure is modest in relation to capital adequacy and management's abilities. Asset quality is of minimal supervisory concern.

A rating of 2 indicates satisfactory asset quality and credit administration practices. The level and severity of classifications and other weaknesses warrant a limited level of supervisory attention. Risk exposure is commensurate with capital adequacy and management's abilities.

A rating of 3 is assigned when asset quality or credit administration practices are less than satisfactory. Trends may be stable or indicate deterioration in asset quality or an increase in risk exposure. The level and severity of classified assets, other weaknesses, and risk require an elevated level of supervisory concern. There is generally a need to improve credit administration and risk management practices.

A rating of 4 is assigned to credit unions with deficient asset quality or credit administration practices. The levels of risk and problem assets are significant, inadequately controlled, and subject the credit union to potential losses that, if left unchecked, may threaten the credit union's viability.

A rating of 5 represents critically deficient asset quality or credit administration practices that present an imminent threat to the credit union's viability.

## **MANAGEMENT**

The capabilities of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of a credit union's activities and to ensure a credit union's safe, sound, and efficient operation in compliance with applicable laws and regulations is reflected in this rating. Generally, directors need not be actively involved in day-to-day operations; however, they provide clear guidance establishing acceptable risk exposure levels thru appropriate policies, procedures, and practices. Senior management is responsible for developing and implementing policies, procedures, and practices that translate the board's goals, objectives, and risk limits into prudent operating standards.

Management practices need to address the seven risk categories and other risks commensurate with the nature and scope of a credit union's activities. Sound management practices are demonstrated by active oversight by the board of directors and management; competent personnel; adequate policies, processes, and controls taking into consideration the size and sophistication of the credit union; maintenance of an appropriate audit program and internal control environment; and effective risk monitoring and management information systems. This rating should reflect the board's and management's ability as it applies to all aspects of the credit union's operations as well as other financial service activities in which the credit union is involved.

The ability of management to respond to changing business conditions, or the initiation of new activities or products, is an important factor in evaluating a credit union's overall risk profile and the level of supervisory attention warranted. For this reason, the management component is given special consideration when assigning the composite rating. The capability and performance of management and the board of directors is also rated based upon, but not limited to, an assessment of the following evaluation factors:

### **CORPORATE GOVERNANCE**

The board of directors and management have a fiduciary responsibility to the members to maintain very high standards of professional conduct including but not limited to:

1. Appropriateness of compensation policies. Management compensation policies should be supported. The board needs to ensure performance standards are in place for senior management and an effective formal evaluation process is used and documented.

2. Avoidance of conflict of interest. Appropriate policies and procedures for avoidance of conflicts of interest and management of potential conflicts of interest should be in place.

3. Professional ethics and behavior. The board of directors and management should not use the credit union for unauthorized or inappropriate personal gain. Credit union property should not be used for anything other than authorized activities. Management should act ethically and impartially in carrying out appropriate credit union policies and procedures.

## **STRATEGIC PLANNING**

Strategic planning involves a systematic process to develop a long-term vision for the credit union. The strategic plan incorporates all areas of a credit union's operations and sets broad goals enabling credit union management to make sound decisions. The strategic plan should identify risks and threats to the organization and outline methods to address them.

As part of the strategic planning process, credit unions should develop a business plan for the next one or two years. The board of directors should review and approve the business plan, including a budget, in the context of its consistency with the credit union's strategic plan. The business plan is evaluated against the strategic plan to determine if the two are consistent. Examiners also assess how the plan is put into effect. The plans should be unique to and reflective of the individual credit union.

Information systems and technology (IS&T) should be included as an integral part of the credit union's strategic plan. Examiners assess the credit union's risk analysis, policies, and oversight of this area based on the size and complexity of the credit union and the type and volume of e-commerce systems and services<sup>2</sup> offered. Examiners consider the criticality of e-commerce systems and services in their assessment of the overall IS&T plan.

## **INTERNAL CONTROLS**

Internal controls play a crucial role in controlling a credit union's risks. Effective internal controls provide safeguards against system malfunctions, errors in judgment, and fraud. Without proper internal controls, management will not be able to identify and track the credit union's exposure to risk. Controls are also essential to enable management to ensure operating units are acting within the parameters established by the board of directors and senior management.

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<sup>2</sup> E-commerce services include those services a credit union provides, and member accesses, via electronic means including, but not limited to: Internet/World Wide Web services, wireless services, home banking (direct dial in) services, online bill paying services, and account transaction processing services.

The following seven aspects of internal controls deserve special attention:

1. Information Systems. It is crucial that effective controls are in place to ensure the integrity, security, and privacy of information contained on the credit union's computer systems.
2. Segregation of Duties. The credit union should have adequate segregation of duties in every area of operation. Segregation of duties may be limited by the number of employees in smaller credit unions.
3. Audit Program. Audit functions and processes should be commensurate with the credit union's size, sophistication, and risk. The program should be independent, reporting to the supervisory committee without conflict or interference from management. An annual audit plan is necessary to ensure risk areas are examined, and the areas of greatest risk receive priority. Reports should be issued to management for comment and action and forwarded to the board of directors with management's response. Follow-up of any unresolved issues is essential and should be covered in subsequent reports.
4. Record Keeping. The books of every credit union should be kept in accordance with well-established accounting principles. A credit union's records and accounts should reflect its actual financial condition and accurate results of operations. Records should be current and provide an audit trail. The audit trail should include sufficient documentation to follow a transaction from its inception through to its completion. Subsidiary records should be kept in balance with general ledger control figures.
5. Protection of Physical Assets. A principal method of safeguarding assets is to limit access to authorized personnel. Protection of assets can be accomplished by developing operating policies and procedures for cash control, joint custody (dual control), teller operations, and physical security of the computer.
6. Education of Staff. Credit union staff and volunteers should be thoroughly trained in specific daily operations. A training program tailored to meet management needs should be in place and cross-training programs for office staff should be present. Risk is controlled when the credit union is able to maintain continuity of operations and service to members.

## **OTHER MANAGEMENT ISSUES**

Other key factors considered when assessing the management of a credit union follow. The order of these factors does not signify a level of importance.

- ❑ Adequacy of the policies and procedures covering each area of the credit union's operations (written, board approved, followed);
- ❑ Budget performance compared against actual performance;
- ❑ Effectiveness of systems that measure and monitor risk;
- ❑ Risk-taking practices and methods of control to mitigate concerns;
- ❑ Integration of risk management with planning and decision-making;
- ❑ Responsiveness to examination and audit suggestions, recommendations, or requirements;
- ❑ Compliance with laws and regulations;
- ❑ Appropriateness of the products and services offered in relation to the credit union's size and management experience;
- ❑ Market penetration;
- ❑ Rate structure;
- ❑ Appropriateness of disaster preparedness planning for continuity of operations; and;
- ❑ Succession planning for key management positions.

## **RATINGS**

A rating of 1 indicates sound performance by management and the board of directors and sound risk management practices relative to the credit union's size complexity, and risk profile. All significant risks are consistently and effectively identified, measured, monitored, and controlled. Management and the board have demonstrated the ability to promptly and successfully address existing and potential problems and risks.

A rating of 2 indicates satisfactory management and board practices relative to the credit union's size, complexity, and risk profile. In general, significant risks are effectively identified, measured, monitored, and controlled. Management and the board have demonstrated the ability to promptly and successfully address existing and potential problems and risks. Minor weaknesses may exist but are not material.

A rating of 3 indicates management and board performance that needs improvement or risk management practices that are less than satisfactory given the nature of the credit union's activities. Problems and significant risks may be inadequately identified, measured, monitored, and controlled. The capabilities of management or the board of directors may be insufficient for the type, size, or condition of the institution.

A rating of 4 indicates deficient management and board performance or risk management practices that are inadequate considering the nature of a credit union's activities. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action by the board and management to



preserve the soundness of the institution. Replacing or strengthening the board may be necessary.

A rating of 5 indicates critically deficient management and board performance or risk management practices. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk management practices. Problems and significant risks are inadequately measured, monitored, or controlled and now threaten the continued viability of the institution. Replacing or strengthening management or the board of directors is necessary.

## **EARNINGS**

This rating reflects the adequacy of current and future earnings to fund capital commensurate with the credit union's current and prospective financial and operational risk exposure, potential changes in economic climate, and strategic plans. Earnings can be affected by excessive or inadequately managed credit risk that may result in loan losses and require additions to the allowance for loan and lease losses, or by market risk that may unduly expose a credit union's earnings to volatility in interest rates. The quality of earnings may also be diminished by undue reliance on extraordinary gains or nonrecurring events. Future earnings may be adversely affected by an inability to forecast or control funding and operating expenses, improperly executed or ill-advised business strategies, or poorly managed or uncontrolled exposure to other risks.

The rating of a credit union's earnings is based upon, but not limited to, an assessment of the following evaluation factors. The order of these factors does not signify a level of importance.

- ❑ Quality and sources of earnings;
- ❑ Ability to fund capital commensurate with current and prospective risk through retained earnings;
- ❑ Adequacy of valuation allowances;
- ❑ Adequacy of budgeting systems, forecasting processes, and management information systems, in general;
- ❑ Future earnings adequacy under a variety of economic conditions;
- ❑ Quality and composition of assets;
- ❑ Earnings exposure to market risk including interest rate risk; and
- ❑ Material factors affecting the credit union's income producing ability such as fixed assets and other non-earning assets.

## **RATINGS**

A rating of 1 indicates earnings that are sound. Adequate capital and allowance levels already exist after consideration is given to asset quality, growth, and risk factors.

A rating of 2 indicates earnings that are satisfactory. Earnings are sufficient to reach adequate capital and allowance levels after consideration is given to asset quality, growth, and risk factors.

A rating of 3 indicates earnings that need to be improved. Earnings may not fully support current and future capital and allowance funding commensurate with the credit union's overall condition, growth, and risk factors.

A rating of 4 indicates earnings that are deficient. Earnings are insufficient to support current and future capital and allowance funding commensurate with the credit union's overall condition, growth, and risk factors.

A rating of 5 indicates earnings that are critically deficient and represent a distinct threat to the credit union's viability. Earnings do not support current and future capital and allowance funding commensurate with the credit overall condition, growth, and risk factors.

## **LIQUIDITY AND ASSET-LIABILITY MANAGEMENT**

### **Liquidity**

In evaluating the adequacy of the credit union's liquidity position, consideration should be given to the current and prospective sources of liquidity compared to funding needs. Consideration is also given to the adequacy of asset-liability management (ALM) practices relative to the credit union's size, complexity, and risk profile. In general, ALM management practices should ensure the credit union is able to maintain liquidity sufficient to meet financial obligations in a timely manner and meet member share and loan demands. Practices should reflect the ability of the credit union to manage unplanned changes in funding sources as well as react to changes in market conditions that affect the ability to quickly liquidate assets with minimal loss. In addition, ALM practices should ensure liquidity is not maintained at high cost or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

The liquidity management system should be commensurate with the complexity of the balance sheet and adequacy of capital. This includes evaluating the mechanisms in place to monitor and control risk, management's response when

risk exposure approaches or exceeds the credit union's risk limits, and corrective action taken when necessary.

## **Asset-Liability Management**

Asset-liability Management (ALM) is the process of evaluating, monitoring, and controlling changes in the credit union's market and balance sheet risk. These risks can adversely affect earnings and capital adequacy. When evaluating ALM, consideration should be given to management's ability to identify, measure, monitor, and control risk, the credit union's size, the nature and complexity of its activities, and the adequacy of capital and earnings in relation to its level of market risk exposure. The primary source of market risk arises from sensitivity to changes in interest rates.

This rating will reflect the overall adequacy of established policies, limits, and the effectiveness of risk optimization strategies. These policies should outline individual responsibilities, the credit union's risk tolerance, and ensure timely monitoring and reporting to the decision makers.

Other factors to consider in evaluating liquidity and asset/liability management are listed below. The order of these factors does not signify a level of importance.

- ❑ Interest-rate risk exposure at the instrument, portfolio, and balance sheet levels;
- ❑ Balance sheet structure;
- ❑ Liquidity management;
- ❑ Qualifications of asset-liability management personnel;
- ❑ Quality of oversight by the board and senior management;
- ❑ Earnings and capital adequacy over changing economic climates;
- ❑ Prudence of policies and risk limits;
- ❑ Business plan, budgets, and projections;
- ❑ Contingency planning to meet unanticipated liquidity events;
- ❑ Contingency planning to handle periods of excess liquidity;
- ❑ Cash flow budgets and projections; and
- ❑ Integration of liquidity management and ALM with planning and decision-making.

## **RATINGS**

A rating of 1 indicates liquidity and ALM practices are sound. There is minimal potential that the capital adequacy will be materially affected by internal and external factors such as a shift in interest rates. Liquidity and ALM are sound for the size, sophistication, and risk taken by the credit union. The degree of market

risk taken by the credit union is supported. The credit union has reliable access to sufficient sources of funds on favorable terms to meet present and anticipated liquidity needs.

A rating of 2 indicates satisfactory liquidity and ALM practices. The credit union has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weaknesses may be evident in ALM. Market rate sensitivity is adequately controlled and there is only moderate potential that the adequacy of capital will be materially affected by internal and external factors such as a shift in interest rates. ALM practices are satisfactory for the size, sophistication, and market risk accepted by the credit union. The degree of market risk taken by the credit union is supported.

A rating of 3 indicates liquidity and/or ALM practices in need of improvement. Credit unions rated a 3 may lack ready access to funds on reasonable terms or may evidence significant weaknesses in ALM practices. Control of market risk needs improvement or there is significant potential the adequacy of capital will be materially affected by internal and external factors such as a shift in interest rates. Risk management practices need to be improved given the size, sophistication, and level of market risk accepted by the credit union. The degree of market risk taken by the credit union is not adequately supported.

A rating of 4 indicates deficient liquidity and/or inadequate ALM practices. Credit unions rated a 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs. The control of market risk is unacceptable or there is high potential the adequacy of capital will be materially affected by internal and external factors such as a shift in interest rates. ALM practices are deficient for the size, sophistication, and level of market risk accepted by the credit union. The degree of market risk taken by the credit union is not supported.

A rating of 5 indicates liquidity and/or ALM practices so critically deficient that the continued viability of the credit union is threatened. Credit unions rated 5 require immediate external financial assistance to meet maturing obligations or other liquidity needs. Market risk sensitivity is unacceptable or the level of the risk taken is an imminent threat to the credit union's viability. ALM practices are inadequate for the size, sophistication, and level of market risk accepted by the credit union.

## FINANCIAL TRENDS IN FEDERALLY INSURED CREDIT UNIONS

January 1 – September 30, 2007

### HIGHLIGHTS

This report summarizes the trends of all federally insured credit unions that reported as of September 30, 2007. Change is measured from December 31, 2006.<sup>1</sup>

- **Assets** increased \$34.43 billion or 4.85% to \$744.43 billion. This equates to an annualized asset growth rate of 6.47%.
- **Net Worth** increased \$3.72 billion or 4.54%. The net worth to assets ratio decreased slightly from 11.53% to 11.50%.
- **Earnings**, as measured by the return on average assets, decreased from 0.82% to 0.75%.<sup>2</sup>
- **Loans** increased \$24.81 billion or 5.02% (6.69% annualized). The loan to share ratio increased from 82.23% to 82.66%.
- **Delinquent** loans as a percentage of total loans increased from 0.68% to 0.81%.
- **Net Loan Charge-Offs** (annualized) increased \$179.67 million or 8.30%.
- **Shares** increased \$26.91 billion or 4.48%. This represents an annual share growth rate of 5.97%. The majority of the growth in shares continues to come from share certificates and money market accounts.
- **Current members** increased by 1.2 million or 1.42%.

Number of Credit Unions Reporting		
	Federal CUs	State CUs
2002	5,953	3,735
2003	5,776	3,593
2004	5,572	3,442
2005	5,393	3,302
2006	5,189	3,173
Sep 2007	5,068	3,095

Federally insured credit unions continued their solid performance in the first nine months of 2007. Loans, shares, and net worth grew; however, the delinquent loan ratio increased 13 basis points and the loan loss ratio increased 1 basis point indicating increasing potential concerns in credit quality of loan portfolios. While net interest margins continued to decline, credit unions achieved favorable operating results. Real estate loans remain the dominant loan category in credit unions, highlighting the need for continued vigilance in underwriting and sound asset-liability management practices.

Total Shares and Deposits	2006 In Billions	Sep 2007 In Billions	% Change
Insured Shares & Deposits	\$535.13	\$556.09	3.92%
Uninsured Shares & Deposits	\$66.06	\$72.01	9.01%

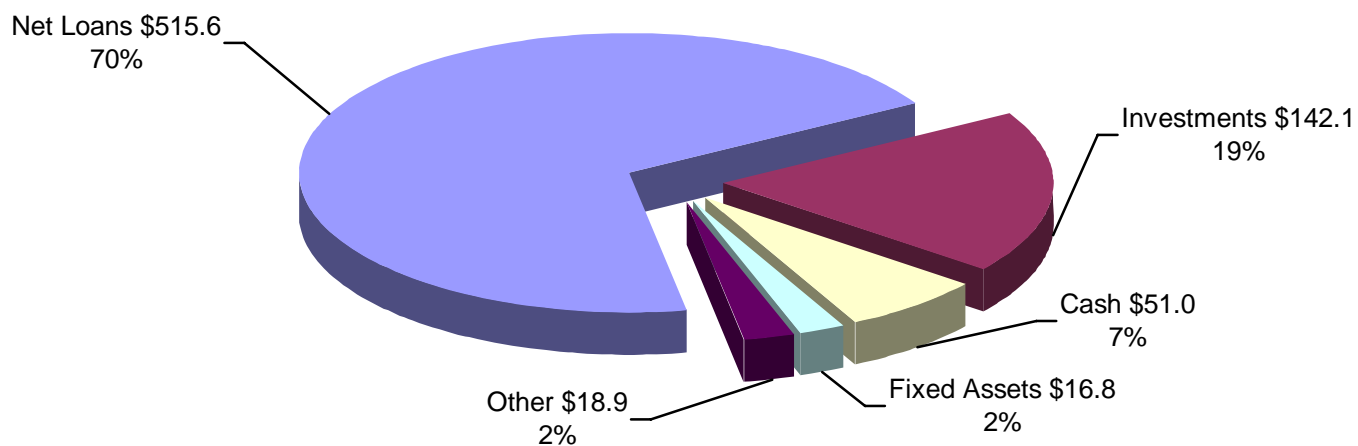
<sup>1</sup> The financial results for prior periods may reflect changes when compared to the prior period trend letters due to subsequent call report modifications.

<sup>2</sup> The Return on Average Assets ratio is annualized net income divided by average assets for the period.

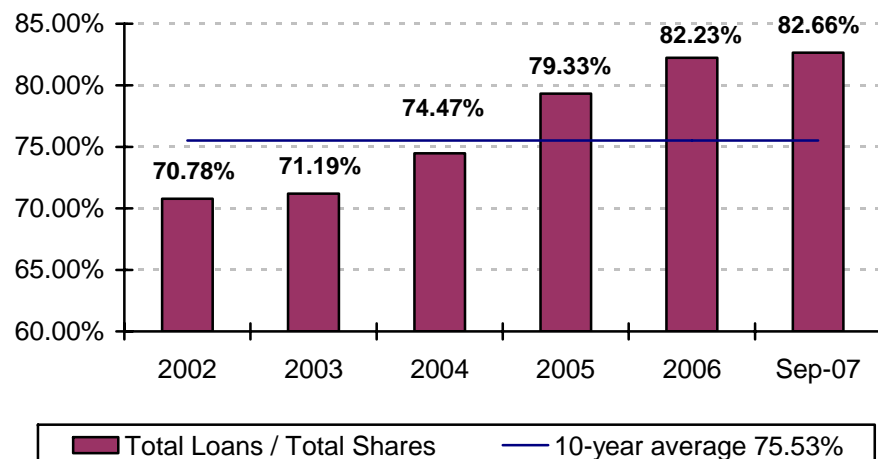
## OVERALL TRENDS

### ASSET DISTRIBUTION

(Billions of Dollars)

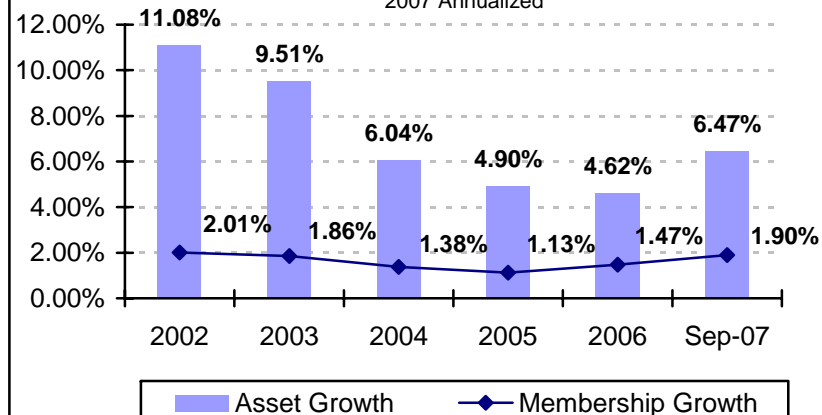


### TOTAL LOANS / TOTAL SHARES

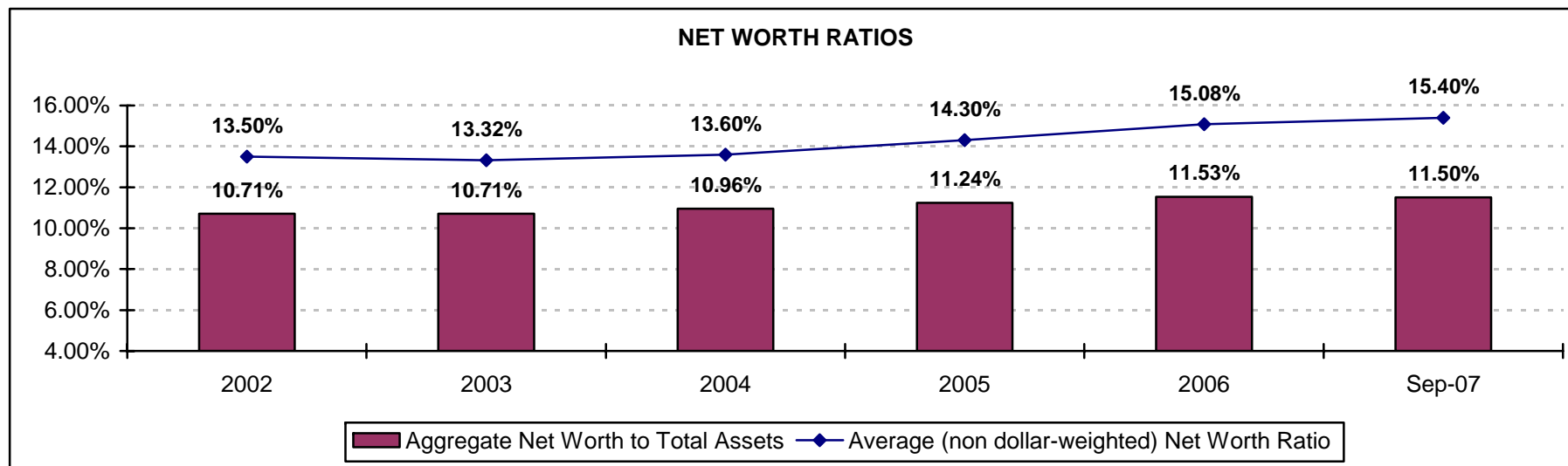


### ASSET GROWTH VS. MEMBERSHIP GROWTH

2007 Annualized



# NET WORTH



	December 2006 In Billions	September 2007 In Billions	% Change
Total Net Worth	\$81.92	\$85.64	4.54%
Secondary Capital	\$.027	\$.028	0.95%

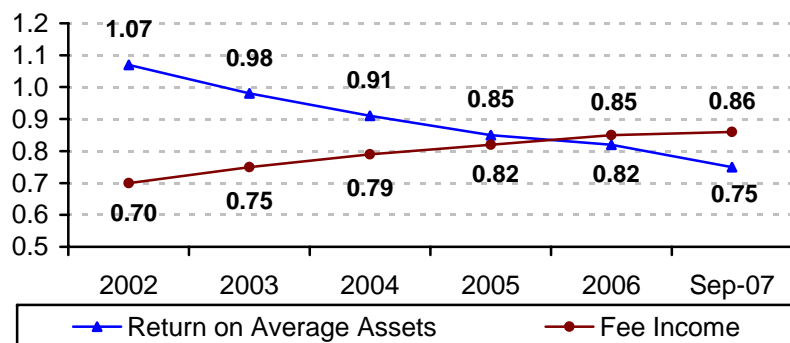
NET WORTH RATIOS				
Number of Credit Unions	December 2006	% of Total	September 2007	% of Total
7% or above	8,235	98.48%	8,056	98.69%
<b>Net Worth Ratios</b>				
6% to 6.99%	58	0.69%	50	0.61%
4% to 5.99%	36	0.43%	33	0.40%
2% to 3.99%	20	0.24%	14	0.17%
0% to 2.00%	8	0.10%	2	0.02%
Less than 0%	5	0.06%	8	0.10%

Net Worth remains strong as total dollars increased \$3.72 billion or 4.54% during the first nine months of 2007. The number of credit unions subject to Prompt Corrective Action, as a percentage of total credit unions, decreased from 1.52% as of December 31, 2006, to 1.31% as of September 30, 2007.

# EARNINGS

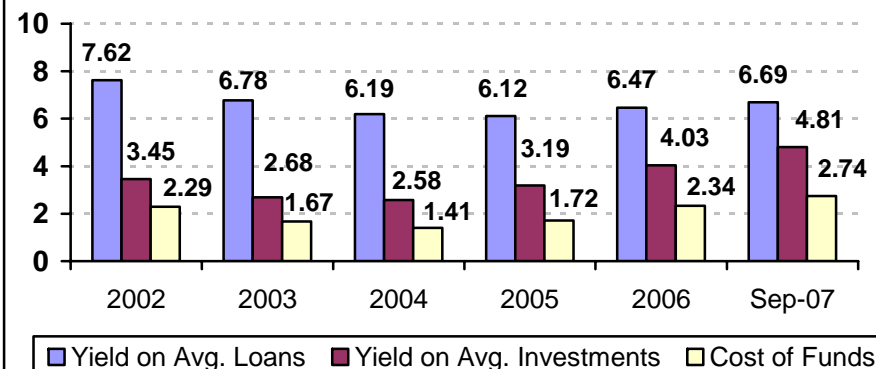
**RETURN ON AVERAGE ASSETS VS FEE INCOME**

(Percentages)



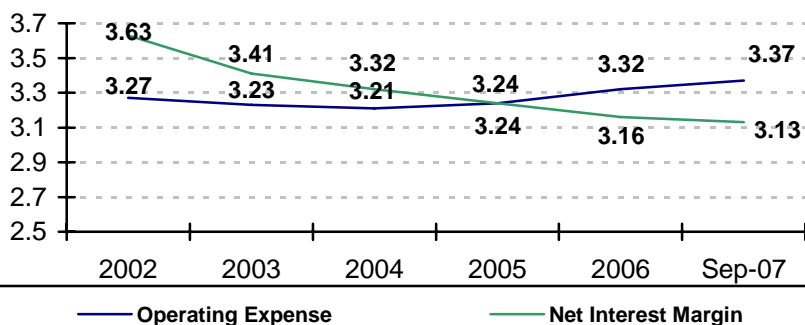
**YIELDS VS. COST OF FUNDS**

(Percentages)



**OPERATING EXPENSES VS NET INTEREST MARGIN**

(Percentages)

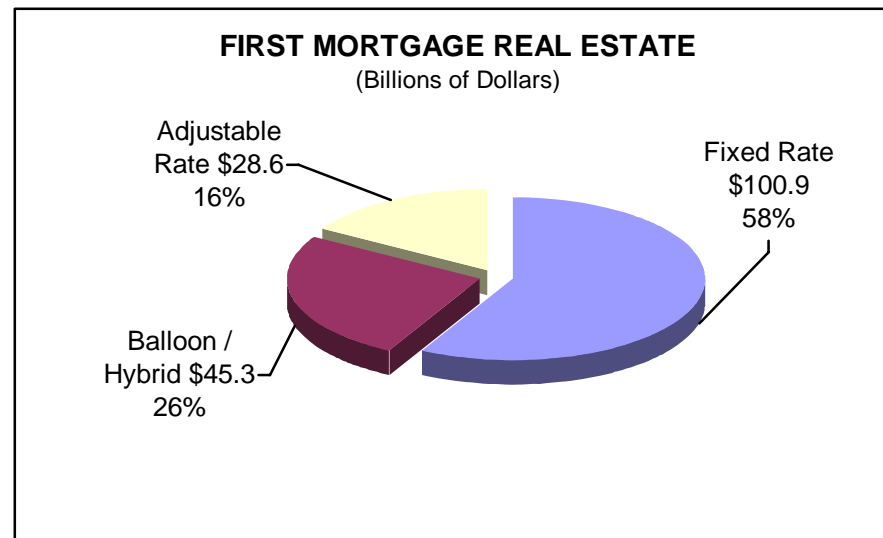
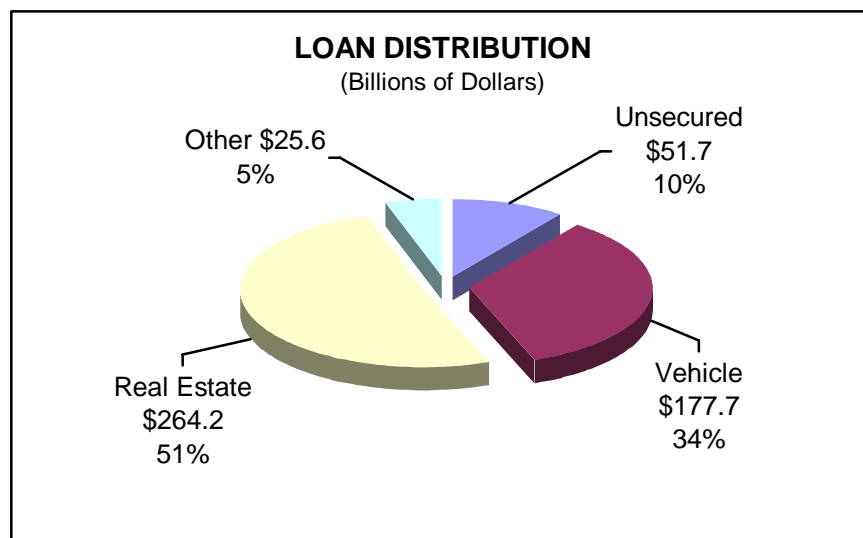


Ratio (% Average Assets)	As of 2006	As of Sept 2007	Effect on ROA
Net Interest Margin	3.16%	3.13%	- 3bp
+ Fee & Other Inc.	1.28%	1.32%	+ 4bp
- Operating Expenses	3.32%	3.37%	- 5bp
- PLLL	0.32%	0.37%	- 5bp
+ Non-Opr. Income	0.02%	0.04%	+ 2bp
= ROA	0.82%	0.75%	- 7bp

The level of earnings continues to be effective, covering the cost of operations as well as contributing to the already solid level of net worth. Net interest margin contracted 3 basis points to 3.13% as the cost of funds increased at a faster rate than the yield on assets. Operating expenses and Provision for Loan & Lease Losses continue to rise in relation to average assets.



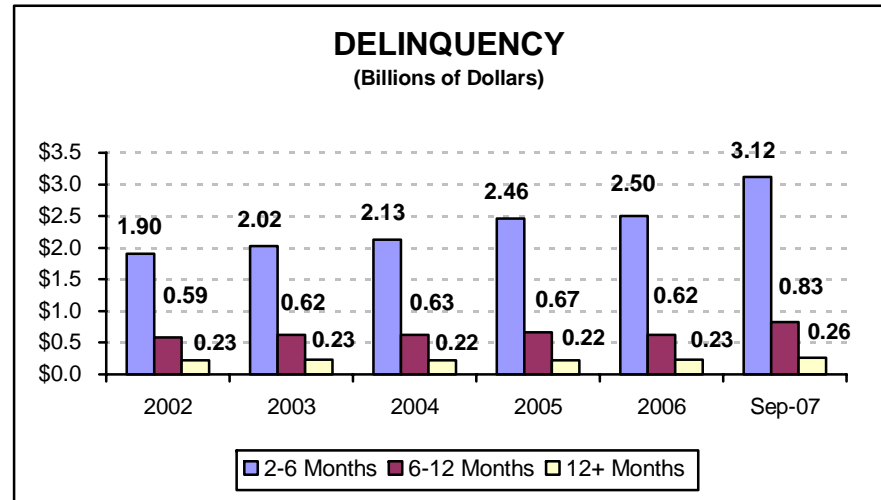
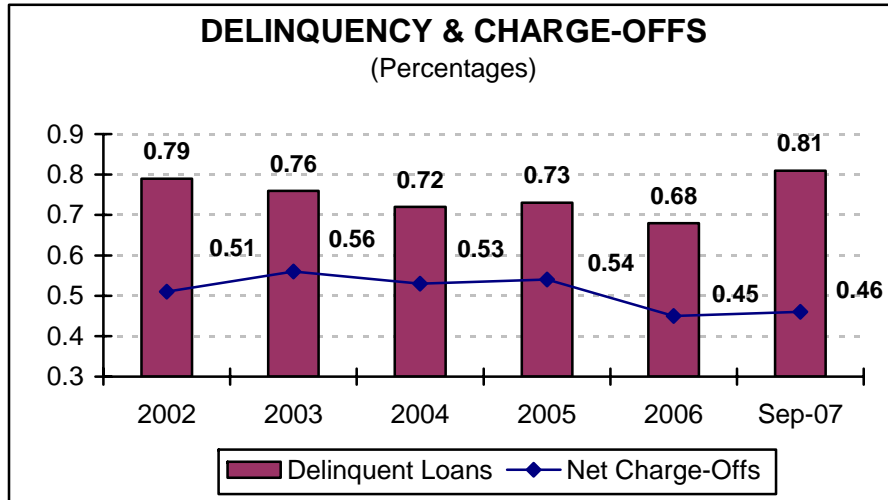
## LOAN DISTRIBUTION



Loan Category	2006 Balance In Billions	% of Total Loans 2006	September 2007 Balance In Billions	% of Total Loans Sep 2007	Growth In Billions	Growth Rate
Unsecured Credit Card	\$26.57	5.37%	\$28.01	5.39%	\$1.44	5.41%
All Other Unsecured	\$22.62	4.58%	\$23.73	4.57%	\$1.11	4.91%
New Vehicle	\$88.53	17.91%	\$88.22	16.99%	-\$0.31	-0.35%
Used Vehicle	\$87.58	17.71%	\$89.41	17.22%	\$1.83	2.10%
First Mortgage Real Estate	\$159.80	32.32%	\$174.77	33.66%	\$14.97	9.37%
Other Real Estate	\$84.37	17.07%	\$89.43	17.23%	\$5.06	6.00%
Leases Rec & All Other	\$24.92	5.04%	\$25.63	4.94%	\$0.71	2.84%
<b>Total Loans</b>	<b>\$494.39</b>		<b>\$519.20</b>		<b>\$24.81</b>	<b>5.02%</b>

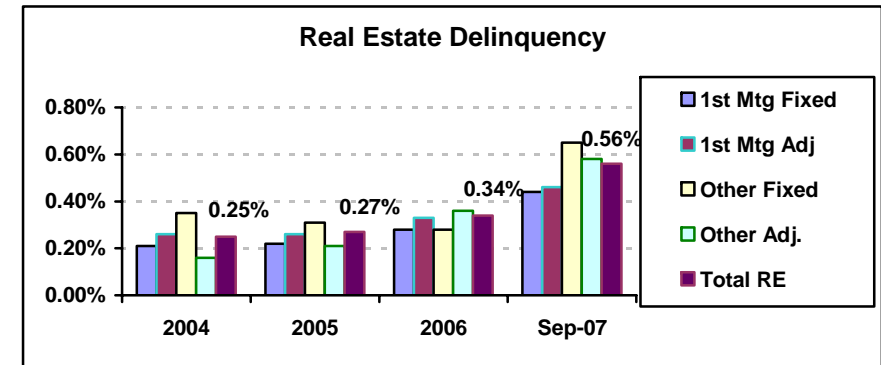
Loan growth outpaced share growth during the first nine months of 2007 with total loans increasing \$24.81 billion, resulting in the loan to share ratio increasing from 82.23% to 82.66%. The growth was again fueled by first mortgages and other real estate loans. Real estate loans comprise the largest portion of total loans at 50.89%, followed by vehicle loans at 34.21%. During the first nine months of 2007, fixed rate first mortgages increased \$9.99 billion (10.99%), adjustable rate first mortgages increased \$0.98 billion (3.53%), and balloon/hybrid first mortgages increased \$4.00 billion (9.70%). Credit unions are reporting \$5.6 billion or 3.21% of total first mortgage loans in Interest Only & Optional Payment First Mortgage Loans.

## DELINQUENCY TRENDS



Total Loan Charge-Offs and Recoveries and Outstanding Foreclosed Real Estate	December 2006 In Billions	Sep 2007 In Billions	% Change
Total Loans Charged Off	\$2.67	\$2.89*	8.05%*
Total Loan Recoveries	\$0.51	\$0.55*	6.99%*
Total Net Charge-Offs	\$2.16	\$2.34*	8.30%*
Foreclosed Real Estate	\$0.16	\$0.27	65.66%

\*Annualized

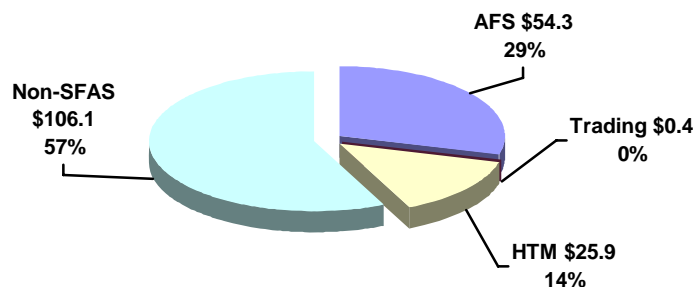


The quality of the loan portfolio deteriorated slightly as noted by a 13 basis point increase in delinquent loans to total loans during the first nine months of 2007, while the average net charge-off ratio increased only 1 basis point. There are some signs of stress in the performance of real estate loans, and the increasing real estate delinquency and loan losses are starting to impact the performance of the overall loan portfolio, as noted in the total delinquency and net charge-off numbers. Total delinquent real estate loans greater than 2 months increased from 0.34% at year-end 2006 to 0.56% as of September 30, 2007. All real estate delinquency categories increased with the largest being in Other Real Estate Fixed/Hybrid/Balloon loans which increased from 0.28% as of year-end 2006 to 0.65% as of September 30, 2007.

## INVESTMENT TRENDS

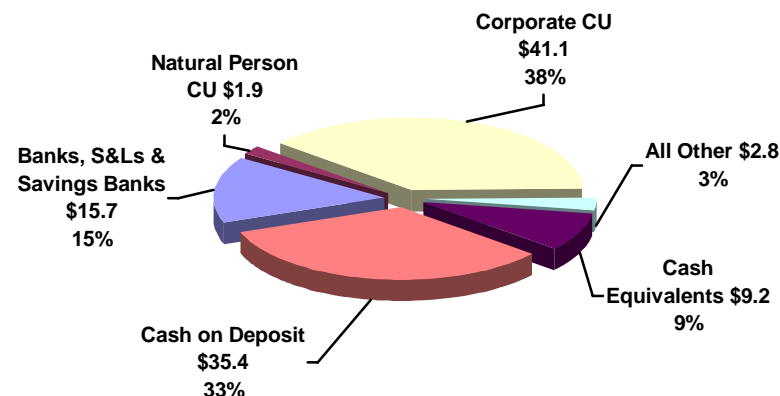
### SFAS 115 INVESTMENT CLASSIFICATION

(Billions of Dollars)



### TOTAL NON-SFAS 115 INVESTMENT DISTRIBUTION

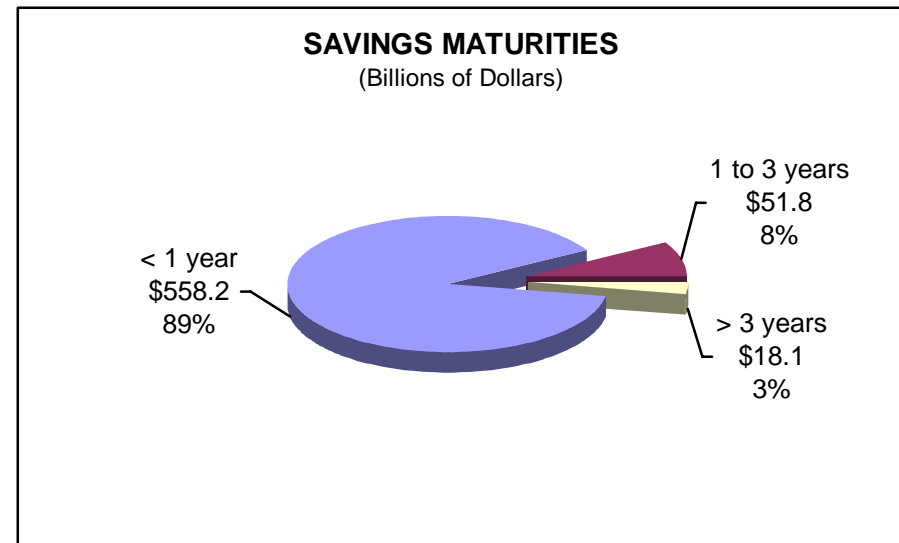
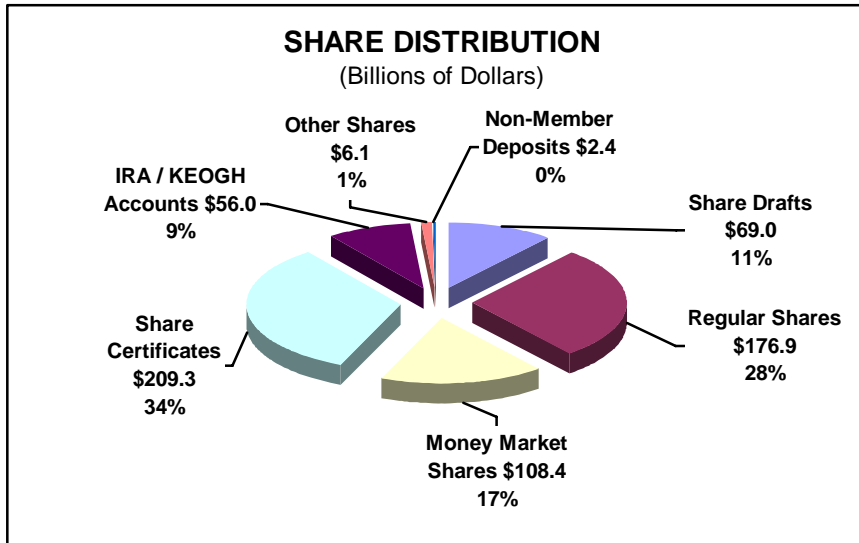
(Billions of Dollars)



Investment Maturity or Repricing Intervals	December 2006 In Billions	% of Total Investments 2006	September 2007 In Billions	% of Total Investments September 2007
Less than 1 year	\$105.83	58.95%	\$109.68	58.74%
1 to 3 years	\$51.96	28.94%	\$49.11	26.30%
3 to 5 years	\$14.45	8.05%	\$18.56	9.94%
5 to 10 years	\$5.17	2.88%	\$6.81	3.65%
Greater than 10 years	\$2.10	1.17%	\$2.56	1.37%
<b>Total Investments</b>	<b>\$179.51</b>		<b>\$186.72</b>	

Strong loan demand outpaced share growth, decreasing the amount of funds available for investment in 2007. The maturity structure of the investment portfolio remains very short, resulting in a low interest rate risk profile for this portion of the balance sheet. Credit unions maintain their investments in high quality, safe instruments. Almost 57% of investments are in cash or equivalents, deposits in corporate credit unions, and deposits in other financial institutions. These provide liquidity and are generally not vulnerable to changing market values. Of the remaining investments, which are subject to SFAS 115 classification, 84.9% are in U.S. Government or Federal Agency Securities.

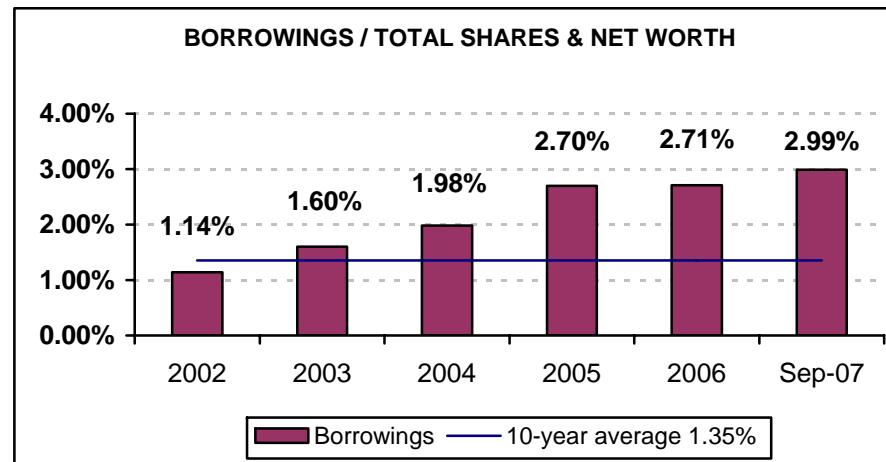
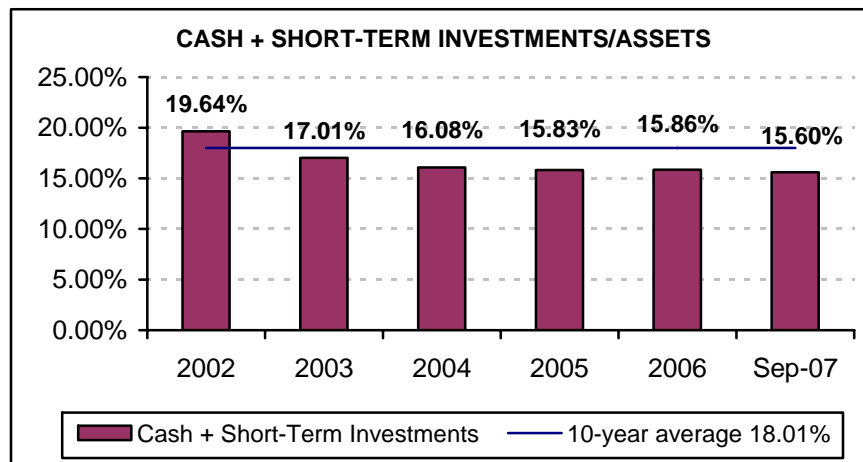
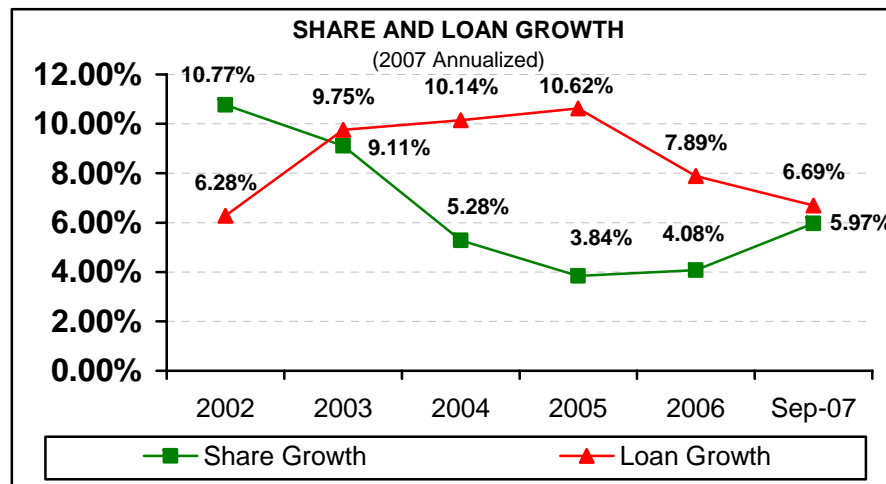
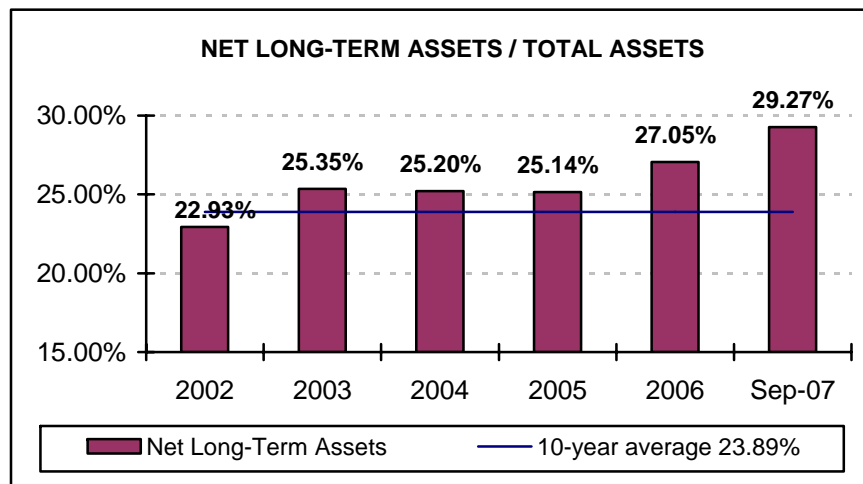
## SHARE TRENDS



Share Category	2006 Balance In Billions	% of Total Shares 2006	September 2007 Balance In Billions	% of Total Shares Sept 2007	Growth In Billions	Growth Rate
Share Drafts	\$70.29	11.69%	\$68.96	10.98%	-\$1.34	-1.90%
Regular Shares	\$181.12	30.13%	\$176.88	28.16%	-\$4.24	-2.34%
Money Market Shares	\$100.46	16.71%	\$108.35	17.25%	\$7.90	7.86%
Share Certificates	\$188.89	31.42%	\$209.28	33.32%	\$20.39	10.79%
IRA / KEOGH Accounts	\$52.04	8.66%	\$56.04	8.92%	\$4.01	7.70%
All Other Shares	\$5.55	0.92%	\$6.15	0.98%	\$0.59	10.70%
Non-Member Deposits	\$2.84	0.47%	\$2.44	0.39%	-\$0.40	-13.95%
<b>Total Shares</b>	<b>\$601.19</b>		<b>\$628.10</b>		<b>\$26.91</b>	<b>4.48%</b>

Total shares grew 4.48% (\$26.91 billion) in the first nine months of 2007. Strong growth in money market shares, IRA/KEOGH accounts and certificates accounted for the majority of the growth. During the period, regular shares and share draft balances declined overall. Total share certificates continue to be the largest category exceeding regular shares for the fourth consecutive quarter.

## ASSET LIABILITY MANAGEMENT TRENDS



Credit unions continue to hold adequate levels of liquidity; however, trends are showing tightening liquidity. The decline in cash and short-term investments during the first nine months of 2007 is due to the strong loan growth outpacing share growth. The net long-term asset ratio of 29.27% presents potential interest rate risk exposure. Credit unions with higher levels of liquidity risk or interest rate risk must maintain diligent liquidity and interest rate risk management procedures.

## SUMMARY OF TRENDS BY ASSET GROUP

	<b>Asset Group</b> Under \$10 million	<b>Asset Group</b> \$10 million to \$100 million	<b>Asset Group</b> \$100 million to \$500 million	<b>Asset Group</b> Over \$500 million
# of Credit Unions	3,625	3,320	913	305
Total Assets	\$13.58 billion	\$114.78 billion	\$196.28 billion	\$419.79 billion
Average Assets (non dollar-weighted)	\$3.75 million	\$34.57 million	\$214.98 million	\$1.38 billion
Net Worth/Total Assets	16.60%	13.26%	11.85%	10.69%
Average Net Worth (non dollar-weighted)	18.02%	13.89%	11.85%	11.20%
Net Worth Growth	-2.47%	2.16%	0.74%	10.89%
Return on Average Assets	0.62%	0.68%	0.65%	0.82%
Net Interest Margin/Average Assets	4.26%	3.80%	3.35%	2.80%
Fee & Other Income/Average Assets	0.71%	1.26%	1.46%	1.29%
Operating Expense/Average Assets	4.06%	4.11%	3.80%	2.92%
Members / Full-Time Employees	447.52	396.43	350.21	385.22
Provision for LLL/Average Assets	0.33%	0.30%	0.40%	0.38%
Loans/Shares	72.14%	74.38%	81.73%	85.75%
Delinquent Loans/Total Loans	2.14%	1.14%	0.96%	0.63%
% of Real Estate Lns Delinquent > 2 Mths	1.11%	0.79%	0.90%	0.38%
Net Charge-Offs/Average Loans	0.53%	0.45%	0.46%	0.47%
Share Growth	-6.07%	0.29%	-0.18%	11.31%
Loan Growth	-7.43%	-1.27%	-0.50%	12.86%
Asset Growth	-5.63%	0.38%	-0.31%	12.19%
Membership Growth	-8.02%	-3.04%	-2.81%	9.07%
Net Long-Term Assets/Total Assets	8.19%	21.94%	30.00%	31.62%
Cash + Short-Term Invest./Assets	30.74%	21.20%	14.89%	13.90%
Borrowings/Shares & Net Worth	0.19%	0.55%	1.89%	4.31%

**Note:** The growth trends are an aggregate figure and do not account for the credit unions which moved into or out of adjoining asset groups.

There is a distinct difference in the performance among the different asset groups. Net worth ratios are solid among all asset groups with the largest percentages being reported in the under \$10 million category. The highest return on average assets, loan growth, share growth, and loan to share ratio is noted in the over \$500 million asset group, with this group being the only one to report positive loan and membership growth for the first nine months of 2007.

# **NCUA LETTER TO CREDIT UNIONS**

**NATIONAL CREDIT UNION ADMINISTRATION  
1775 Duke Street, Alexandria, VA 22314**

**DATE: December 2007                      LETTER NO.: 07-CU-11**

**TO: Federally Insured Credit Unions**

**SUBJ: Credit Union Financial Trends for the Third Quarter of 2007**

**ENCL: Financial Trends in Federally Insured Credit Unions  
January 1 – September 30, 2007**

**Dear Board of Directors:**

Enclosed is a report highlighting credit union financial trends for the first nine months of 2007. We based our analysis on data compiled from the quarterly call reports submitted by all federally insured credit unions.

The financial condition of the credit union industry remains sound, as indicated by strong share growth, and high net worth levels. However, delinquency, especially in the real estate portfolio, is starting to increase. Consistent with the last several years, the majority of the loan growth in 2007 continues to come from the real estate area.

Credit unions with a large or increasing real estate loan portfolio need to maintain vigilance in their asset-liability management and liquidity management planning processes, as well as address the credit risk implications in light of ongoing developments in the real estate sector of the market. Credit unions must continue to balance member service with safety and soundness considerations when structuring their products and services.

Thank you for your cooperation in submitting your financial and statistical data in a timely manner.

Sincerely,

/s/

JoAnn Johnson  
Chairman

# **NCUA LETTER TO CREDIT UNIONS**

## **NATIONAL CREDIT UNION ADMINISTRATION**

**1775 Duke Street, Alexandria, VA 22314**

**DATE: July 2007**

**LETTER NO.: 07-CU-09**

**TO: Federally Insured Credit Unions**

**SUBJ: Subprime Mortgage Lending**

**ENCL: Interagency Statement on Subprime Mortgage Lending**

Dear Board of Directors,

The purpose of this letter is to provide all federally insured credit unions with the finalized Interagency Statement on Subprime Mortgage Lending (Statement). The enclosed Statement was issued jointly by the agencies of the Federal Financial Institutions Examination Council (Agencies) to address emerging risks and lending practices associated with certain subprime adjustable rate mortgage (ARM) products that can cause payment shock.<sup>1</sup>

Credit unions should be aware that whether or not they are actively participating in subprime mortgage lending, some members may have received these types of loans at other institutions. Asset quality could be negatively impacted as some members struggle to repay considerably higher mortgage payments. In any case, federally insured credit unions should consider the sound business practices discussed in the attached Statement as they offer subprime mortgage loans or work to resolve subprime mortgage loan concerns with members.

The Statement addresses prudent risk management practices for institutions offering certain types of ARM products. Credit unions offering these types of products should observe these prudent risk management practices, which include:

- Ensuring lending practices are not predatory in nature;

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<sup>1</sup> The Agencies consist of the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, and Office of Thrift Supervision.



- Assessing a borrower's capacity to repay a loan, considering the fully-indexed interest rate and assuming a fully amortizing repayment schedule; and
- Underwriting loans using stated income or reduced documentation only when there are mitigating factors offsetting the need to verify repayment ability.

Additionally, the Statement outlines prudent consumer protection standards and underscores the need for strong control systems to ensure risk management and consumer protection standards are met. The Statement also encourages credit unions to work constructively with residential mortgage borrowers through prudent workout agreements that are consistent with safe and sound lending practices when borrowers are in or approaching default. Finally, the Statement reminds institutions that the Agencies will continue to closely review risk management and consumer protection policies, practices, and procedures.

If you have any questions regarding the enclosed document, please contact your district examiner, regional office, or state supervisory authority.

Sincerely,

/s/

JoAnn Johnson  
Chairman

Enclosure

**[OCC-20%-4810-33-P]  
[Board-20%-6210-01-P]  
[FDIC-20%-6714-01-P]  
[OTS-20%-6720-01-P]  
[NCUA-20%-7535-01-P]**

**DEPARTMENT OF THE TREASURY**

**Office of the Comptroller of the Currency**

**[Docket No. OCC-2007-0005]**

**FEDERAL RESERVE SYSTEM**

**[Docket No. OP-1278]**

**FEDERAL DEPOSIT INSURANCE CORPORATION**

**DEPARTMENT OF THE TREASURY**

**Office of Thrift Supervision**

**[No. 2007-31]**

**NATIONAL CREDIT UNION ADMINISTRATION**

**Statement on Subprime Mortgage Lending**

**AGENCIES:** Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Office

of Thrift Supervision, Treasury (OTS); and National Credit Union Administration (NCUA) (collectively, the Agencies).

**ACTION:** Final guidance – Statement on Subprime Mortgage Lending.

**SUMMARY:** The Agencies are issuing a final interagency Statement on Subprime Mortgage Lending. This guidance has been developed to clarify how institutions can offer certain adjustable rate mortgage (ARM) products in a safe and sound manner, and in a way that clearly discloses the risks that borrowers may assume.

**EFFECTIVE DATE:** [INSERT DATE OF PUBLICATION IN FEDERAL REGISTER].

**FOR FURTHER INFORMATION CONTACT:**

OCC: Michael Bylsma, Director, Community and Consumer Law Division, (202) 874-5750 or Stephen Jackson, Director, Retail Credit Risk, (202) 874-5170.

Board: Division of Banking Supervision and Regulation: Brian P. Valenti, Supervisory Financial Analyst, (202) 452-3575, Virginia M. Gibbs, Senior Supervisory Financial Analyst, (202) 452-2521, or Sabeth I. Siddique, Assistant Director, (202) 452-3861; Division of Consumer and Community Affairs: Kathleen C. Ryan, Counsel, (202) 452-3667, or Jamie Z. Goodson, Attorney, (202) 452-3667; or Legal Division: Kara L. Handzlik, Attorney (202) 452-3852. Board of Governors of the Federal Reserve System, 20<sup>th</sup> Street and Constitution Avenue, NW., Washington, DC 20551. Users of Telecommunication Device for Deaf only, call (202) 263-4869.

FDIC: Beverlea S. Gardner, Examination Specialist, (202) 898-3640, Division of Supervision and Consumer Protection; Richard B. Foley, Counsel (202) 898-3784; Mira N. Marshall, Acting Chief Community Reinvestment Act and Fair Lending, (202) 898-3912; April

A. Breslaw, Acting Associate Director, Compliance Policy & Exam Support Branch, Division of Supervision and Consumer Protection, (202) 898-6609.

OTS: Tammy L. Stacy, Director of Consumer Regulation, Compliance and Consumer Protection Division, (202) 906-6437; Glenn Gimble, Senior Project Manager, Compliance and Consumer Protection Division, (202) 906-7158; William J. Magrini, Senior Project Manager, Credit Risk, (202) 906-5744; or Teresa Luther, Economist, Credit Risk, (202) 906-6798.

NCUA: Cory W. Phariss, Program Officer, Examination and Insurance, (703) 518-6618.

## **SUPPLEMENTARY INFORMATION:**

### **I. Background**

The Agencies developed this Statement on Subprime Mortgage Lending to address emerging risks associated with certain subprime mortgage products and lending practices. In particular, the Agencies are concerned about the growing use of ARM products<sup>1</sup> that provide low initial payments based on a fixed introductory rate that expires after a short period, and then adjusts to a variable rate plus a margin for the remaining term of the loan. These products could result in payment shock to the borrower. The Agencies are concerned that these products, typically offered to subprime borrowers, present heightened risks to lenders and borrowers. Often, these products have additional characteristics that increase risk. These include qualifying borrowers based on limited or no documentation of income or imposing substantial prepayment penalties or prepayment penalty periods that extend beyond the initial fixed interest rate period. In addition, borrowers may not be adequately informed of product features and risks, including

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<sup>1</sup> For example, ARMs known as “2/28” loans feature a fixed rate for two years and then adjust to a variable rate for the remaining 28 years. The spread between the initial fixed interest rate and the fully indexed interest rate in effect at loan origination typically ranges from 300 to 600 basis points.

their responsibility to pay taxes and insurance, which might be separate from their mortgage payments.

These products originally were extended to customers primarily as a temporary credit accommodation in anticipation of early sale of the property or in expectation of future earnings growth. However, these loans have more recently been offered to subprime borrowers as “credit repair” or “affordability” products. The Agencies are concerned that many subprime borrowers may not have sufficient financial capacity to service a higher debt load, especially if they were qualified based on a low introductory payment. The Agencies are also concerned that subprime borrowers may not fully understand the risks and consequences of obtaining this type of ARM loan. Borrowers who obtain these loans may face unaffordable monthly payments after the initial rate adjustment, difficulty in paying real estate taxes and insurance that were not escrowed, or expensive refinancing fees, any of which could cause borrowers to default and potentially lose their homes.

In response to these concerns, the Agencies published for comment the *Proposed Statement on Subprime Mortgage Lending* (proposed statement), 72 FR 10533 (March 8, 2007). The proposed statement provided guidance on the criteria and factors, including payment shock, that an institution should assess in determining a borrower’s ability to repay the loan. The proposed statement also provided guidance intended to protect consumers from unfair, deceptive, and other predatory practices, and to ensure that consumers are provided with clear and balanced information about the risks and features of these loans. Finally, the proposed statement addressed the need for strong controls to adequately manage the risks associated with these products.

The Agencies requested comment on all aspects of the proposed statement, and specifically requested comment about whether: 1) these products always present inappropriate risks to institutions and consumers, or the extent to which they may be appropriate under some circumstances; 2) the proposed statement would unduly restrict the ability of existing subprime borrowers to refinance their loans, and whether other forms of credit are available that would not present the risk of payment shock; 3) the principles of the proposed statement should be applied beyond the subprime ARM market; and 4) limitations on the use of prepayment penalties would help meet borrower needs.

The Agencies collectively received 137 unique comments on the proposed statement. Comments were received from financial institutions, industry-related trade associations (industry groups), consumer and community groups, government officials, and members of the public.

## **II. Overview of Public Comments**

The commenters were generally supportive of the Agencies' efforts to provide guidance in this area. However, many financial institution commenters expressed concern that certain aspects of the proposed statement were too prescriptive or could unduly restrict subprime borrowers' access to credit. Many consumer and community group commenters stated that the proposed statement did not go far enough in addressing their concerns about these products.

Financial institutions and industry groups stated that they supported prudent underwriting, but opposed a strict requirement that ARM loans subject to the proposed statement be underwritten at a fully indexed rate with a fully amortizing repayment schedule. They also stated that these loan products are not always inappropriate, particularly because they can be a useful credit repair vehicle or a means to establish a favorable credit history. Many of these commenters expressed concern that the proposed statement would unduly restrict credit to

subprime borrowers. They also requested that the proposed statement be modified to allow lenders flexibility in helping existing subprime borrowers refinance out of ARM loans that will reset to a monthly payment that they cannot afford.

The majority of financial institutions and industry group commenters opposed the application of the proposed statement outside the subprime market. A number of these commenters requested clarification of the scope of the proposed statement and the definition of “subprime.”

Some industry group commenters also expressed concern that consumer disclosure requirements would put federally-regulated institutions at a disadvantage and cause consumer information overload. They also requested that any changes to consumer disclosure requirements be part of a comprehensive reform of existing disclosure regulations.

Consumer and community group commenters generally supported the proposed statement. Many of these commenters expressed their concern that the products covered by the proposed statement present inappropriate risks for subprime borrowers. Many of these commenters supported extending the scope of the proposed statement to other mortgage products. These commenters supported the proposed underwriting criteria, though a number of them suggested stricter underwriting criteria. They also supported further limiting or prohibiting the use of reduced documentation and stated income loans, suggesting that such a reduction would be in the best interests of consumers.

Both industry group and consumer and community group commenters expressed concern that the proposed statement will not apply to all lenders. Industry group commenters indicated this would put federally-regulated financial institutions at a competitive disadvantage. Consumer and community group commenters encouraged the Agencies to continue to work with state

regulators to extend the principles of the proposed statement to non-federally supervised institutions. Since the time that the Agencies announced the proposed statement, the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) issued a press release confirming their intent to “develop a parallel statement for state supervisors to use with state-supervised entities.”<sup>2</sup>

### **III. Agencies’ Action on Final Joint Guidance**

The Agencies are issuing the *Statement on Subprime Mortgage Lending* (Statement) with some changes to respond to the comments received and to provide additional clarity. The Statement applies to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions. Significant comments on specific provisions of the proposed statement, the Agencies’ responses, and changes to the proposed statement are discussed below.

#### **Scope of Guidance**

A number of financial institution and industry group commenters and two credit reporting companies requested that the definition of “subprime” be clarified. A financial institution and an industry group commenter requested a bright-line test to determine if a borrower falls into the subprime category.

The Agencies considered commenters’ requests that a definition of “subprime” be included in the Statement. The Agencies determined, however, that the reference to the

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<sup>2</sup> Media Release, CSBS & AARMR, “CSBS and AARMR Support Interagency Statement on Subprime Lending” (March 2, 2007), available at <http://www.csbs.org/AM/Template.cfm?Section=Search&template=/CM/HTMLDisplay.cfm&ContentID=10295>.



subprime borrower characteristics from the *2001 Expanded Guidance for Subprime Lending Programs* (Expanded Guidance) provides appropriate information for purposes of this Statement. The Expanded Guidance provides a range of credit risk characteristics that are associated with subprime borrowers, noting that the characteristics are illustrative and are not meant to define specific parameters for all subprime borrowers.<sup>3</sup> Because the term “subprime” is not consistently defined in the marketplace or among individual institutions, the Agencies believe that incorporating the subprime borrower credit risk characteristics from the Expanded Guidance provides sufficient clarity.

A number of commenters also requested clarification as to whether the proposed statement applies to all products with the features described. In addition, the Agencies specifically requested comment regarding whether the proposed statement’s principles should be applied beyond the subprime ARM market. All consumer and community groups and some of the financial institutions who addressed this question supported application of the proposed statement beyond the subprime market. However, most financial institution and industry group commenters opposed application of the proposed statement beyond the subprime market. These commenters stated that the issues the proposed statement was designed to address are confined to the subprime market and expansion of the proposed statement to other markets would unnecessarily limit the options available to other borrowers.

As with the proposed statement, the Statement retains a focus on subprime borrowers, due to concern that these consumers may not fully understand the risks and consequences of these loans and may not have the financial capacity to deal with increased obligations. The Agencies did revise the language to indicate that the proposed statement applies to certain ARM

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<sup>3</sup> Federally insured credit unions should refer to LCU 04-CU-13 – *Specialized Lending Activities*.

products that have one or more characteristics that can cause payment shock, as defined in the proposed statement. While the Statement has retained its focus on subprime borrowers, the Agencies note that institutions generally should look to the principles of this Statement when such ARM products are offered to non-subprime borrowers.

### **Risk Management Practices**

#### **Predatory Lending Considerations**

Some financial institution and industry group commenters raised concerns that the proposed statement implied that subprime lending is “per se” predatory. The Statement clarifies that subprime lending is not synonymous with predatory lending, and that there is no presumption that the loans to which the Statement applies are predatory.

#### **Qualifying Standards**

The proposed statement provided that subprime ARMs should be underwritten at the fully indexed rate with a fully amortizing repayment schedule. Many consumer and community groups supported the proposed statement’s underwriting standards. Other consumer and community groups thought that the proposed qualifying standards did not go far enough, and suggested that these loans should be underwritten on the basis of the maximum possible monthly payment. The majority of industry group commenters who addressed this issue opposed the proposed underwriting standard as overly prescriptive. Some commenters also requested that the Statement define “fully indexed rate with a fully amortizing repayment schedule.” All of the commenters that addressed the issue favored including a reasonable estimate of property taxes and insurance in an assessment of borrowers’ debt-to-income ratios.

The Agencies continue to believe that institutions should maintain qualification standards that include a credible analysis of a borrower’s capacity to repay the loan according to its terms.

This analysis should consider both principal and interest obligations at the fully indexed rate with a fully amortizing repayment schedule, plus a reasonable estimate for real estate taxes and insurance, whether or not escrowed. Qualifying consumers based on a low introductory payment does not provide a realistic assessment of a borrower's ability to repay the loan according to its terms. Therefore, the proposed general guideline of qualifying borrowers at the fully indexed rate, assuming a fully amortizing payment, remains unchanged in the final Statement. The Agencies did, however, provide additional information regarding the terms "fully indexed rate" and "fully amortizing payment schedule" to clarify expectations regarding how institutions should assess borrowers' repayment capacity.

#### **Reduced Documentation or Stated Income Loans**

Several commenters raised concerns about reduced documentation or stated income loans. The majority of commenters who addressed this issue supported the proposed statement's position that institutions should be able to readily document income for many borrowers and that reduced documentation should be accepted only if mitigating factors are present. A few financial institution and industry group commenters urged the Agencies to allow lenders some flexibility in deciding when these loans are appropriate for borrowers whose income is derived from sources that are difficult to verify. On the other hand, some consumer and community group commenters stated that borrowers are not always given the option to document income and thereby pay a lower interest rate. They also indicated that stated income loans may be a vehicle for fraud in that borrower income may be inflated to qualify for a loan.

The Agencies believe that verifying income is critical to conducting a credible analysis of borrowers' repayment capacity, particularly in connection with loans to subprime borrowers. Therefore, the final Statement provides that stated income and reduced documentation should be

accepted only if there are mitigating factors that clearly minimize the need for verification of repayment capacity. The Statement provides some examples of mitigating factors, and sets forth an expectation that reliance on mitigating factors should be documented. The Agencies note that for many borrowers, institutions should be able to readily document income using recent W-2 statements, pay stubs, and/or tax returns.

### **Workout Arrangements**

The Agencies specifically requested comment on whether the proposed statement would unduly restrict the ability of existing subprime borrowers to refinance out of certain ARMs to avoid payment shock. The Agencies also asked about the availability to these borrowers of other mortgage products that do not present the risk of payment shock. The majority of financial institution and industry group commenters who responded to this specific question believed that the proposed statement would unduly restrict existing subprime borrowers' ability to refinance. However, most consumer and community groups who addressed the issue expressed the view that allowing existing borrowers to refinance into another unaffordable ARM was not an acceptable solution to the problem and, therefore, that eliminating this option would not be an undue restriction on credit. Some commenters mentioned that certain government sponsored entities and lenders have already committed to revise their lending program criteria and/or create new programs that potentially may provide alternative mortgage products for refinancing existing subprime loans.

To address these issues, the Agencies incorporated a section on workout arrangements in the final text that references the principles of the April 2007 interagency *Statement on Working with Borrowers*. The Agencies believe prudent workout arrangements that are consistent with

safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower.

### **Consumer Protection Principles**

#### **Prepayment Penalties**

The Agencies specifically requested comment regarding whether prepayment penalties should be limited to the initial fixed-rate period; how this practice, if adopted, would assist consumers and affect institutions; and whether an institution's providing a window of 90 days prior to the reset date to refinance without a prepayment penalty would help meet borrower needs. The overwhelming majority of commenters who addressed this question agreed that prepayment penalties should be limited to the initial fixed-rate period, and several commenters proposed a complete prohibition of prepayment penalties. Commenters suggested different time frames for expiration of the prepayment penalty period, ranging from 30 to 90 days prior to the reset date. Several industry group commenters, however, opposed such a limitation. They stated that prepayment fees are a legitimate means for lenders and investors to be compensated for origination costs when borrowers prepay prior to the interest rate reset. Further, these commenters noted that most lenders do not offer mortgage products that have prepayment penalty periods that extend beyond the fixed interest rate period and that borrowers should be allowed time to exit the loan prior to the reset date.

In light of the comments received, the Agencies revised the Statement to state that the period during which prepayment penalties apply should not exceed the initial reset period, and that institutions generally should provide borrowers with a reasonable period of time (typically, at least 60 days prior to the reset date) to refinance their loans without penalty. There is no

supervisory expectation for institutions to waive contractual terms with regard to prepayment penalties on existing loans.<sup>4</sup>

### **Consumer Disclosure Issues**

Many financial institution and industry group commenters suggested that the Agencies' consumer protection goals would be better accomplished through amendments to generally applicable regulations, such as Regulation Z (Truth in Lending)<sup>5</sup> or Regulation X (Real Estate Settlement Procedures).<sup>6</sup> Some financial institution and consumer and community group commenters questioned the value of additional disclosures and expressed concern that the proposed statement would contribute to consumer information overload. A few commenters stated that the proposed statement would add burdensome new disclosure requirements and would result in the provision of confusing information to consumers.

Some industry group commenters asked the Agencies to provide uniform disclosures for these products, or to publish illustrations of the consumer information contemplated by the proposed statement similar to those previously proposed by the Agencies in connection with nontraditional mortgage products.<sup>7</sup> Several commenters also requested that any disclosures include the maximum possible monthly payment under the terms of the loan.

The Agencies have determined that, given the growth in the market for the products covered by the Statement and the heightened legal, compliance, and reputation risks associated with these products, guidelines are needed now to ensure that consumers will receive the information they need about the material features of these loans. In addition, while the Agencies

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<sup>4</sup> Federal credit unions are prohibited from charging prepayment penalties. 12 CFR 701.21.

<sup>5</sup> 12 CFR part 226 (2006).

<sup>6</sup> 24 CFR part 3500 (2005).

<sup>7</sup> 71 FR 58673 (October 4, 2006).

are sensitive to commenters' concerns regarding disclosure burden, we do not anticipate that the information outlined in the Statement will result in additional lengthy disclosures. Rather, the Agencies contemplate that the information can be provided in a brief narrative format and through the use of examples based on hypothetical loan transactions. In response to requests by commenters, the Agencies are working on and expect to publish for comment proposed illustrations of the type of consumer information contemplated in the Statement.

The Agencies disagree with the commenters who expressed concern that the proposed statement appears to establish a suitability standard under which lenders would be required to assist borrowers in choosing products that are appropriate to their needs and circumstances. These commenters argued that lenders are not in a position to determine which products are most suitable for borrowers, and that this decision should be left to borrowers themselves. It is not the Agencies' intent to impose such a standard, nor is there any language in the Statement that does so.

### **Control Systems**

While some commenters who addressed the control systems portion of the proposed statement supported the Agencies' proposal, some industry group commenters expressed concern that these provisions were neither realistic nor practical. A few industry group commenters requested clarification of the scope of a financial institution's responsibilities with regard to third parties. Some consumer and community group commenters requested uniform regulation of and increased enforcement against third parties.

The Agencies have carefully considered these comments, but have not revised this portion of the proposed statement. The Agencies do not expect institutions to assume an unwarranted

level of responsibility for the actions of third parties. Moreover, the control systems discussed in the Statement are consistent with the Agencies' current supervisory authority and policies.

### **Supervisory Review**

The Agencies received no comments on the supervisory review portion of the proposed statement. However, minor changes have been made to clarify the circumstances under which the Agencies will take action against institutions in connection with the products addressed in the Statement.

## **IV. Text of Final Joint Guidance**

The final interagency Statement on Subprime Mortgage Lending appears below.

### **Statement on Subprime Mortgage Lending**

The Agencies<sup>8</sup> developed this Statement on Subprime Mortgage Lending (Subprime Statement) to address emerging issues and questions relating to certain subprime<sup>9</sup> mortgage lending practices. The Agencies are concerned borrowers may not fully understand the risks and consequences of obtaining products that can cause payment shock.<sup>10</sup> In particular, the Agencies are concerned with certain adjustable-rate mortgage (ARM) products typically offered to subprime borrowers that have one or more of the following characteristics:

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<sup>8</sup> The Agencies consist of the Board of Governors of the Federal Reserve System (the Board), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).

<sup>9</sup> The term "subprime" is described in the 2001 *Expanded Guidance for Subprime Lending Programs*. Federally insured credit unions should refer to LCU 04-CU-13 – *Specialized Lending Activities*.

<sup>10</sup> Payment shock refers to a significant increase in the amount of the monthly payment that generally occurs as the interest rate adjusts to a fully indexed basis. Products with a wide spread between the initial interest rate and the fully indexed rate that do not have payment caps or periodic interest rate caps, or that contain very high caps, can produce significant payment shock.



- Low initial payments based on a fixed introductory rate that expires after a short period and then adjusts to a variable index rate plus a margin for the remaining term of the loan;<sup>11</sup>
- Very high or no limits on how much the payment amount or the interest rate may increase (“payment or rate caps”) on reset dates;
- Limited or no documentation of borrowers’ income;
- Product features likely to result in frequent refinancing to maintain an affordable monthly payment; and/or
- Substantial prepayment penalties and/or prepayment penalties that extend beyond the initial fixed interest rate period.

Products with one or more of these features present substantial risks to both consumers and lenders. These risks are increased if borrowers are not adequately informed of the product features and risks, including their responsibility for paying real estate taxes and insurance, which may be separate from their monthly mortgage payments. The consequences to borrowers could include: being unable to afford the monthly payments after the initial rate adjustment because of payment shock; experiencing difficulty in paying real estate taxes and insurance that were not escrowed; incurring expensive refinancing fees, frequently due to closing costs and prepayment penalties, especially if the prepayment penalty period extends beyond the rate adjustment date; and losing their homes. Consequences to lenders may include unwarranted levels of credit,

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<sup>11</sup> For example, ARMs known as “2/28” loans feature a fixed rate for two years and then adjust to a variable rate for the remaining 28 years. The spread between the initial fixed interest rate and the fully indexed interest rate in effect at loan origination typically ranges from 300 to 600 basis points.

legal, compliance, reputation, and liquidity risks due to the elevated risks inherent in these products.

The Agencies note that many of these concerns are addressed in existing interagency guidance. The most prominent are the 1993 *Interagency Guidelines for Real Estate Lending (Real Estate Guidelines)*, the 1999 *Interagency Guidance on Subprime Lending*, and the 2001 *Expanded Guidance for Subprime Lending Programs (Expanded Subprime Guidance)*.<sup>12</sup>

While the 2006 *Interagency Guidance on Nontraditional Mortgage Product Risks (NTM Guidance)* may not explicitly pertain to products with the characteristics addressed in this Statement, it outlines prudent underwriting and consumer protection principles that institutions also should consider with regard to subprime mortgage lending. This Statement reiterates many of the principles addressed in existing guidance relating to prudent risk management practices and consumer protection laws.<sup>13</sup>

## **Risk Management Practices**

### **Predatory Lending Considerations**

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<sup>12</sup> Federally insured credit unions should refer to LCU 04-CU-13 – *Specialized Lending Activities*. National banks also should refer to 12 CFR 34.3(b) and (c), as well as 12 CFR part 30, Appendix C.

<sup>13</sup> As with the *Interagency Guidance on Nontraditional Mortgage Product Risks*, 71 FR 58609 (October 4, 2006), this Statement applies to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions.

Subprime lending is not synonymous with predatory lending, and loans with the features described above are not necessarily predatory in nature. However, institutions should ensure that they do not engage in the types of predatory lending practices discussed in the *Expanded Subprime Guidance*.<sup>14</sup> Typically, predatory lending involves at least one of the following elements:

- Making loans based predominantly on the foreclosure or liquidation value of a borrower's collateral rather than on the borrower's ability to repay the mortgage according to its terms;
- Inducing a borrower to repeatedly refinance a loan in order to charge high points and fees each time the loan is refinanced ("loan flipping"); or
- Engaging in fraud or deception to conceal the true nature of the mortgage loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower.

Institutions offering mortgage loans such as these face an elevated risk that their conduct will violate Section 5 of the Federal Trade Commission Act (FTC Act), which prohibits unfair or deceptive acts or practices.<sup>15</sup>

### **Underwriting Standards**

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<sup>14</sup> Federal credit unions should refer to 12 CFR 740.2 and 12 CFR 706 for information on prohibited practices.

<sup>15</sup> The OCC, the Board, the OTS, and the FDIC enforce this provision under section 8 of the Federal Deposit Insurance Act. The OCC, Board, and FDIC also have issued supervisory guidance to the institutions under their respective jurisdictions concerning unfair or deceptive acts or practices. See OCC Advisory Letter 2002-3—*Guidance on Unfair or Deceptive Acts or Practices*, March 22, 2002, and 12 CFR part 30, Appendix C; Joint Board and FDIC *Guidance on Unfair or Deceptive Acts or Practices by State-Chartered Banks*, March 11, 2004. The OTS also has issued a regulation that prohibits savings associations from using advertisements or other representations that are inaccurate or misrepresent the services or contracts offered (12 CFR 563.27). The NCUA prohibits federally insured credit unions from using any advertising or promotional material that is inaccurate, misleading, or deceptive in any way concerning its products, services, or financial condition (12 CFR 740.2).

Institutions should refer to the *Real Estate Guidelines*, which provide underwriting standards for all real estate loans.<sup>16</sup> The *Real Estate Guidelines* state that prudently underwritten real estate loans should reflect all relevant credit factors, including the capacity of the borrower to adequately service the debt.<sup>17</sup> The 2006 *NTM Guidance* details similar criteria for qualifying borrowers for products that may result in payment shock.

Prudent qualifying standards recognize the potential effect of payment shock in evaluating a borrower's ability to service debt. An institution's analysis of a borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by its final maturity at the fully indexed rate,<sup>18</sup> assuming a fully amortizing repayment schedule.<sup>19</sup>

One widely accepted approach in the mortgage industry is to quantify a borrower's repayment capacity by a debt-to-income (DTI) ratio. An institution's DTI analysis should include, among other things, an assessment of a borrower's total monthly housing-related payments (*e.g.*,

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<sup>16</sup> Refer to 12 CFR part 34, subpart D (OCC); 12 CFR part 208, subpart C (Board); 12 CFR part 365 (FDIC); 12 CFR 560.100 and 12 CFR 560.101 (OTS); and 12 CFR 701.21 (NCUA).

<sup>17</sup> OTS Examination Handbook Section 212, *1-4 Family Residential Mortgage Lending*, also discusses borrower qualification standards. Federally insured credit unions should refer to LCU 04-CU-13- *Specialized Lending Activities*.

<sup>18</sup> The fully indexed rate equals the index rate prevailing at origination plus the margin to be added to it after the expiration of an introductory interest rate. For example, assume that a loan with an initial fixed rate of 7% will reset to the six-month London Interbank Offered Rate (LIBOR) plus a margin of 6%. If the six-month LIBOR rate equals 5.5%, lenders should qualify the borrower at 11.5% (5.5% + 6%), regardless of any interest rate caps that limit how quickly the fully indexed rate may be reached.

<sup>19</sup> The fully amortizing payment schedule should be based on the term of the loan. For example, the amortizing payment for a "2/28" loan would be calculated based on a 30-year amortization schedule. For balloon mortgages that contain a borrower option for an extended amortization period, the fully amortizing payment schedule can be based on the full term the borrower may choose.

principal, interest, taxes, and insurance, or what is commonly known as PITI) as a percentage of gross monthly income.

This assessment is particularly important if the institution relies upon reduced documentation or allows other forms of risk layering. Risk-layering features in a subprime mortgage loan may significantly increase the risks to both the institution and the borrower. Therefore, an institution should have clear policies governing the use of risk-layering features, such as reduced documentation loans or simultaneous second lien mortgages. When risk-layering features are combined with a mortgage loan, an institution should demonstrate the existence of effective mitigating factors that support the underwriting decision and the borrower's repayment capacity.

Recognizing that loans to subprime borrowers present elevated credit risk, institutions should verify and document the borrower's income (both source and amount), assets and liabilities. Stated income and reduced documentation loans to subprime borrowers should be accepted only if there are mitigating factors that clearly minimize the need for direct verification of repayment capacity. Reliance on such factors also should be documented. Typically, mitigating factors arise when a borrower with favorable payment performance seeks to refinance an existing mortgage with a new loan of a similar size and with similar terms, and the borrower's financial condition has not deteriorated. Other mitigating factors might include situations where a borrower has substantial liquid reserves or assets that demonstrate repayment capacity and can be verified and documented by the lender. However, a higher interest rate is not considered an acceptable mitigating factor.

## Workout Arrangements

As discussed in the April 2007 interagency *Statement on Working with Borrowers*, the Agencies encourage financial institutions to work constructively with residential borrowers who are in default or whose default is reasonably foreseeable. Prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower.

Financial institutions should follow prudent underwriting practices in determining whether to consider a loan modification or a workout arrangement.<sup>20</sup> Such arrangements can vary widely based on the borrower's financial capacity. For example, an institution might consider modifying loan terms, including converting loans with variable rates into fixed-rate products to provide financially stressed borrowers with predictable payment requirements.

The Agencies will not criticize financial institutions that pursue reasonable workout arrangements with borrowers. Further, existing supervisory guidance and applicable accounting standards do not require institutions to immediately foreclose on the collateral underlying a loan when the borrower exhibits repayment difficulties. Institutions should identify and report credit risk, maintain an adequate allowance for loan losses, and recognize credit losses in a timely manner.

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<sup>20</sup> Institutions may need to account for workout arrangements as troubled debt restructurings and should follow generally accepted accounting principles in accounting for these transactions.

## **Consumer Protection Principles**

Fundamental consumer protection principles relevant to the underwriting and marketing of mortgage loans include:

- Approving loans based on the borrower's ability to repay the loan according to its terms; and
- Providing information that enables consumers to understand material terms, costs, and risks of loan products at a time that will help the consumer select a product.

Communications with consumers, including advertisements, oral statements, and promotional materials, should provide clear and balanced information about the relative benefits and risks of the products. This information should be provided in a timely manner to assist consumers in the product selection process, not just upon submission of an application or at consummation of the loan. Institutions should not use such communications to steer consumers to these products to the exclusion of other products offered by the institution for which the consumer may qualify.

Information provided to consumers should clearly explain the risk of payment shock and the ramifications of prepayment penalties, balloon payments, and the lack of escrow for taxes and insurance, as necessary. The applicability of prepayment penalties should not exceed the initial

reset period. In general, borrowers should be provided a reasonable period of time (typically at least 60 days prior to the reset date) to refinance without penalty.<sup>21</sup>

Similarly, if borrowers do not understand that their monthly mortgage payments do not include taxes and insurance, and they have not budgeted for these essential homeownership expenses, they may be faced with the need for significant additional funds on short notice.<sup>22</sup> Therefore, mortgage product descriptions and advertisements should provide clear, detailed information about the costs, terms, features, and risks of the loan to the borrower. Consumers should be informed of:

- *Payment Shock*. Potential payment increases, including how the new payment will be calculated when the introductory fixed rate expires.<sup>23</sup>
- *Prepayment Penalties*. The existence of any prepayment penalty, how it will be calculated, and when it may be imposed.<sup>24</sup>

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<sup>21</sup> Federal credit unions are prohibited from charging prepayment penalties. 12 CFR 701.21.

<sup>22</sup> Institutions generally can address these concerns most directly by requiring borrowers to escrow funds for real estate taxes and insurance.

<sup>23</sup> To illustrate: a borrower earning \$42,000 per year obtains a \$200,000 “2/28” mortgage loan. The loan’s two-year introductory fixed interest rate of 7% requires a principal and interest payment of \$1,331. Escrowing \$200 per month for taxes and insurance results in a total monthly payment of \$1,531 (\$1,331 + \$200), representing a 44% DTI ratio. A fully indexed interest rate of 11.5% (based on a six-month LIBOR index rate of 5.5% plus a 6% margin) would cause the borrower’s principal and interest payment to increase to \$1,956. The adjusted total monthly payment of \$2,156 (\$1,956 + \$200 for taxes and insurance) represents a 41% increase in the payment amount and results in a 62% DTI ratio.

<sup>24</sup> See footnote 21.



- Balloon Payments. The existence of any balloon payment.
- Cost of Reduced Documentation Loans. Whether there is a pricing premium attached to a reduced documentation or stated income loan program.
- Responsibility for Taxes and Insurance. The requirement to make payments for real estate taxes and insurance in addition to their loan payments, if not escrowed, and the fact that taxes and insurance costs can be substantial.

## **Control Systems**

Institutions should develop strong control systems to monitor whether actual practices are consistent with their policies and procedures. Systems should address compliance and consumer information concerns, as well as safety and soundness, and encompass both institution personnel and applicable third parties, such as mortgage brokers or correspondents.

Important controls include establishing appropriate criteria for hiring and training loan personnel, entering into and maintaining relationships with third parties, and conducting initial and ongoing due diligence on third parties. Institutions also should design compensation programs that avoid providing incentives for originations inconsistent with sound underwriting and consumer protection principles, and that do not result in the steering of consumers to these products to the exclusion of other products for which the consumer may qualify.

Institutions should have procedures and systems in place to monitor compliance with applicable laws and regulations, third-party agreements and internal policies. An institution's controls also should include appropriate corrective actions in the event of failure to comply with applicable laws, regulations, third-party agreements or internal policies. In addition, institutions should initiate procedures to review consumer complaints to identify potential compliance problems or other negative trends.

### **Supervisory Review**

The Agencies will continue to carefully review risk management and consumer compliance processes, policies, and procedures. The Agencies will take action against institutions that exhibit predatory lending practices, violate consumer protection laws or fair lending laws, engage in unfair or deceptive acts or practices, or otherwise engage in unsafe or unsound lending practices.

[THIS SIGNATURE PAGE RELATES TO THE FINAL GUIDANCE TITLED “STATEMENT  
ON SUBPRIME MORTGAGE LENDING”]

Dated:

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John C. Dugan,

Comptroller of the Currency

[THIS SIGNATURE PAGE RELATES TO THE FINAL GUIDANCE TITLED “STATEMENT  
ON SUBPRIME MORTGAGE LENDING”]

By order of the Board of Governors of the Federal Reserve System, [DATE]

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Jennifer J. Johnson

Secretary of the Board

[THIS SIGNATURE PAGE RELATES TO THE FINAL GUIDANCE TITLED “STATEMENT  
ON SUBPRIME MORTGAGE LENDING”]

Dated at Washington, D.C., the 27th day of June, 2007

By order of the Federal Deposit Insurance Corporation

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Robert E. Feldman,

Executive Secretary

[THIS SIGNATURE PAGE RELATES TO THE FINAL GUIDANCE TITLED “STATEMENT  
ON SUBPRIME MORTGAGE LENDING”]

Dated: [\_\_\_\_\_]

By the Office of Thrift Supervision

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John Reich,

Director

[THIS SIGNATURE PAGE RELATES TO THE FINAL GUIDANCE TITLED “STATEMENT  
ON SUBPRIME MORTGAGE LENDING”]

Dated: [\_\_\_\_\_]

By the National Credit Union Administration

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JoAnn M. Johnson,

Chairman

# NCUA LETTER TO CREDIT UNIONS

## NATIONAL CREDIT UNION ADMINISTRATION 1775 Duke Street, Alexandria, VA 22314

**DATE:** May 2007 **LETTER NO.:** 07-CU-07

**TO:** Federally Insured Credit Unions

**SUBJ:** Consumer Information for Nontraditional Mortgage Products

**ENCL:** Illustrations of Consumer Information for  
Nontraditional Mortgage Products

**REF:** Interagency Guidance on Nontraditional Mortgage  
Product Risk

Dear Board of Directors,

The purpose of this Letter is to provide all Federally Insured Credit Unions with the final *Interagency Illustrations of Consumer Information for Nontraditional Mortgage Products*. These illustrations were produced jointly by the Federal Financial Institutions Examination Council (FFIEC<sup>1</sup>) to assist institutions in implementing the consumer information recommendations of the recently issued *Interagency Guidance on Nontraditional Mortgage Product Risk (NTM guidance)*.

The NTM guidance states that institutions offering nontraditional mortgage products should provide consumers with information that is designed to help them make informed decisions when selecting and using these products. Additionally, the guidance states that institutions should provide consumers with timely information about payment shock, negative amortization, prepayment penalties, and the cost of reduced documentation mortgages, where applicable.

The FFIEC developed these illustrations to demonstrate the type of consumer information contemplated by the NTM guidance. The enclosed illustrations are *not* required disclosures or model forms. Credit unions may choose whether or not to use these illustrations in implementing the recommendations of the NTM guidance. Credit unions may also choose to tailor these illustrations to their

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<sup>1</sup> The Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, and Office of Thrift Supervision.



particular circumstances, or provide the recommended consumer information in an appropriate, alternate format. .

If you have any questions regarding the enclosed document, please contact your district examiner, regional office, or state supervisory authority.

Sincerely,

/s/

JoAnn Johnson  
Chairman

Enclosure

**DEPARTMENT OF THE TREASURY**

**Office of the Comptroller of the Currency**

**[Docket No. 06-12]**

**FEDERAL RESERVE SYSTEM**

**[Docket No. OP-1267]**

**FEDERAL DEPOSIT INSURANCE CORPORATION**

**DEPARTMENT OF THE TREASURY**

**Office of Thrift Supervision**

**[No. 2006-36]**

**NATIONAL CREDIT UNION ADMINISTRATION**

**Illustrations of Consumer Information for Nontraditional Mortgage Products**

**AGENCIES:** Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Office of Thrift Supervision, Treasury (OTS); and National Credit Union Administration (NCUA) (collectively, the Agencies).

**ACTION:** Final guidance – Illustrations of Consumer Information for Nontraditional Mortgage Products.

**SUMMARY:** The Agencies are publishing three documents that set forth Illustrations of Consumer Information for Nontraditional Mortgage Products. The illustrations are intended to assist institutions in implementing the consumer protection portion of the Interagency Guidance on Nontraditional Mortgage Product Risks (Interagency NTM Guidance) adopted on October 4, 2006. 71 FR 58609 (Oct. 4, 2006). The illustrations are not model forms and institutions may choose not to use them in providing information to consumers on nontraditional mortgage products as recommended in the Interagency NTM Guidance.

**EFFECTIVE DATE:** [Insert date of publication in Federal Register].

**FOR FURTHER INFORMATION CONTACT:**

OCC: Michael Bylsma, Director, Stephen Van Meter, Assistant Director, or Kathryn Ray, Special Counsel, Community and Consumer Law Division, (202) 874-5750.

Board: Kathleen C. Ryan, Counsel, or Jamie Z. Goodson, Attorney, Division of Consumer and Community Affairs, (202) 452-3667. For users of Telecommunication Device for Deaf only, call (202) 263-4869.

FDIC: April Breslaw, Acting Associate Director, Compliance Policy & Exam Support Branch, Division of Supervision and Consumer Protection, (202) 898-6609; or Richard Foley, Counsel, Legal Division, (202) 898-3784.

OTS: Montrice G. Yakimov, Assistant Managing Director, Compliance and Consumer Protection Division, (202) 906-6173; or Glenn Gimble, Senior Project Manager, Compliance and Consumer Protection Division, (202) 906-7158.

NCUA: Cory Phariss, Program Officer, Examination and Insurance, (703) 518-6618.

## **SUPPLEMENTARY INFORMATION:**

### **I. Background**

On December 29, 2005, the Agencies published the Interagency NTM Guidance for comment. 70 FR 77249 (Dec. 29, 2005). After carefully reviewing and considering all comments received, the Agencies published the Interagency NTM Guidance (applicable to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions) in final form on October 4, 2006. 71 FR 58609 (Oct. 4, 2006).

The Interagency NTM Guidance sets forth recommended practices to ensure that consumers have clear and balanced information about nontraditional mortgages prior to making a mortgage product choice, such as when lenders provide promotional materials about nontraditional mortgages or during face-to-face meetings when consumers are shopping for a mortgage. The guidance also recommends that any monthly statements given with payment option adjustable rate mortgages (ARMs) provide information to enable consumers to make informed payment choices.

Several commenters on the proposed guidance, including industry trade associations, encouraged the Agencies to include model or sample disclosures or other descriptive materials as part of the Interagency NTM Guidance. In response, the Agencies determined that illustrations of consumer information would be useful to institutions as they seek to implement the consumer information recommendations. Therefore, on the same day the Interagency NTM Guidance was published in the Federal Register, the Agencies published for comment proposed Illustrations of

Consumer Information for Nontraditional Mortgage Products (Proposed Illustrations). 71 FR 58673 (Oct. 4, 2006).

The three Proposed Illustrations consisted of (1) a narrative explanation of nontraditional mortgage products, (2) a chart comparing interest only (IO) loans and payment option ARMs to fixed rate and traditional adjustable rate loans, and (3) a table that could be included with any monthly statement for a payment option ARM providing information on the impact of various payment options on the loan balance. The Agencies noted that there would be no Agency requirement or expectation that institutions use the illustrations in their communications with consumers. Instead, the Agencies intended to illustrate the type of information that the Interagency NTM Guidance contemplates. Institutions would be able to determine whether or not to use the illustrations and whether and how to tailor them to their own circumstances.

The Agencies requested comment on all aspects of the Proposed Illustrations. Specifically, they requested commenters to address whether the illustrations, as proposed, would be useful to institutions, including community banks, seeking to implement the “Communications with Consumers” portion of the Interagency NTM Guidance, or whether changes should be made. The Agencies also encouraged specific comment on whether the illustrations, as proposed, would be useful in promoting consumer understanding of the risks and material terms of nontraditional mortgage products, as described in the Interagency NTM Guidance, or whether changes should be made. Finally, the Agencies sought comment on whether other illustrations relating to nontraditional mortgages, in addition to those proposed, would be useful to institutions and consumers.

After considering the comments received, the Agencies are now issuing final illustrations of consumer information for nontraditional mortgage products. The Interagency NTM Guidance

recommends that promotional materials and other product descriptions provide consumers with information about the costs, terms, features, and risks of nontraditional mortgage products that can assist consumers in their product selection decisions. This includes information about potential payment shock and negative amortization and, where applicable, information about prepayment penalties and the costs of reduced documentation loans.

Institutions seeking to follow the recommendations set forth in the Interagency NTM Guidance may, at their option, elect to:

- Use the illustrations;
- Provide information based on the illustrations, but expand, abbreviate, or otherwise tailor any information in the illustrations as appropriate to reflect, for example:
  - the institution's product offerings, such as by deleting information about loan products and loan terms not offered by the institution and by revising the illustrations to reflect specific terms currently offered by the institution;
  - the consumer's particular loan requirements;
  - current market conditions, such as by changing the loan amounts, interest rates, and corresponding payment amounts to reflect current local market circumstances;
  - other information, consistent with the Interagency NTM Guidance, such as the payment and loan balance information for statements discussed in connection with Illustration No. 3 or information about when a prepayment penalty may be imposed; and
  - the results of consumer testing of such forms; or

- Provide the information described in the Interagency NTM Guidance, as appropriate, in an alternate format.

To assist institutions that wish to use the illustrations, the Agencies will be posting each of the illustrations on their respective websites in a form that can be downloaded and printed for easy reproduction. In addition, in response to concerns that the interest rates used in Illustration No. 2 may become outdated with changes in market interest rates – and consistent with the Agencies’ intention, expressed above, that the illustrations may be modified to reflect, among other things, current market conditions – the Agencies also will be posting on their respective websites a template that can be used by institutions that wish to modify the information presented in Illustration No. 2 to reflect more current interest rates (and corresponding payment amounts). Illustration No. 2 itself reflects typical interest rates for prime borrowers in today’s environment, rounded to the nearest whole number to enhance simplicity.<sup>1</sup>

## **II. Overview of the Comments**

Collectively, the Agencies received letters from over 30 commenters on the proposal, including comments from two financial institutions, 12 consumer advocates and community organizations, 12 trade organizations, two individuals, and three state regulatory organizations.

Most commenters generally approved of the illustrations and expressed appreciation for the Agencies’ efforts to demonstrate ways lenders could advance the consumer communication goals outlined in the Interagency NTM Guidance. Generally, commenters stated that the proposed illustrations would be useful to financial institutions – including community banks –

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<sup>1</sup> Illustration No. 2 also embodies assumptions about other product features that are typical in the current market: for example, the illustration assumes that the payment option ARM provides for a cap on increases in the minimum monthly payment equal to 7.5 percent per year for the first 5 years of the loan. Thus, the illustration shows the minimum monthly payment increasing over this time period from \$739 (in Year 1) to \$987 (in Year 5).

seeking to develop their own disclosures to help consumers understand the risks of nontraditional mortgage products. Commenters also suggested that the illustrations provided helpful guidance on the Agencies' expectations and would help reduce implementation costs.

Most financial institutions and trade organizations supported the voluntary nature of the illustrations. These commenters stated that the flexibility afforded them by the Agencies would allow them to convey information to their customers in a format most suited to customers' needs. Additionally, having the flexibility to develop their own disclosures would allow financial institutions to tailor their disclosures to take into account specific product offerings and market conditions.

However, a smaller group of commenters that included 8 consumer groups and one industry group disagreed, and suggested that consumer education efforts should be mandatory. The trade group noted that providing for voluntary use of the illustrations makes unclear the degree to which the illustrations will be used, when they will be used, and how they will assist consumers. This commenter suggested that the Agencies propose model forms and provide lenders with a safe harbor when they use the model forms.

Several financial institutions, trade organizations, and community organizations suggested that the illustrations should be made part of the Board's revisions to Regulation Z, which implements the Truth in Lending Act. These commenters suggested that making the illustrations part of Regulation Z would ensure more widespread industry use. Additionally, some commenters expressed concern that issuing guidance on consumer information materials applicable only to federally-supervised institutions would put those institutions at a competitive disadvantage. The Conference of State Bank Supervisors (CSBS), the American Association of Residential Mortgage Regulators (AARMR), and the National Association of Consumer Credit



Administrators (NACCA) commented that they believe the illustrations also could be used by state-licensed entities subject to state-issued guidance that parallels the Interagency NTM Guidance.

A number of commenters expressed concern that the illustrations were difficult to follow and would be confusing to consumers, and should be simplified. A few industry trade groups and a consumer group advised the Agencies to engage in consumer testing or hire consultants to determine how to improve the illustrations. A number of commenters provided very specific suggestions aimed at making the illustrations easier to understand. Several industry commenters requested that the Agencies add language explaining how a consumer could benefit from nontraditional mortgage products. Further, one trade organization stated that lenders should be able to implement the consumer information recommendations of the Interagency NTM Guidance by providing consumers with the interagency publication titled, “Interest-Only Mortgage Payments and Payment-Option ARMs—Are They for You?”<sup>2</sup>

Finally, two commenters suggested that the Agencies include in these illustrations information about two additional products – 2/28 and 3/27 adjustable rate mortgages. These are “hybrid” ARMs that start with a fixed interest rate for two or three years, respectively, and then reset to a variable rate, which generally will be higher than the introductory fixed rate. Because the Interagency NTM Guidance does not cover fully-amortizing mortgage products such as hybrid ARMs, the Agencies are not including information on these products in the NTM illustrations. However, when the Agencies finalize the “Statement on Subprime Mortgage Lending,” which was proposed on March 8, 2007, and which provides guidance concerning

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<sup>2</sup> “Interest-Only Mortgage Payments and Payment-Option ARMs—Are They for You?” *available at:* [http://www.federalreserve.gov/pubs/mortgage\\_interestonly/mortgage\\_interestonly.pdf](http://www.federalreserve.gov/pubs/mortgage_interestonly/mortgage_interestonly.pdf).

hybrid ARM products, we expect to issue for public comment disclosure illustrations appropriate for that guidance.<sup>3</sup>

### **III. Final Illustrations**

After carefully considering all of the comments received, the Agencies have decided to publish the proposed illustrations, with some modifications. The Agencies have determined that illustrations of the type of information contemplated in the Interagency NTM Guidance are needed now. Additionally, the Agencies believe that issuing the materials as nonmandatory illustrations will provide institutions with the flexibility needed to tailor the materials to their own circumstances and customer needs.

Some commenters asserted that use of the illustrations may place entities subject to the Interagency NTM Guidance at a competitive disadvantage. In this regard, we note that the Interagency NTM Guidance, which includes the consumer disclosure recommendations, is already in effect for these entities, and also has been adopted for state-regulated mortgage brokers and companies by over 30 state agencies and the District of Columbia.<sup>4</sup> The illustrations will be helpful to those institutions that prefer not to incur the costs and burdens of developing their own consumer information documents to implement the recommendations in the Interagency NTM Guidance. Additionally, as previously noted, CSBS, AARMR, and NACCA stated their belief that the illustrations also could be used by state-licensed entities subject to state-issued guidance that parallels the Interagency NTM Guidance.

The Agencies agree with the commenters who urged simplification of the Proposed Illustrations, particularly Proposed Illustration No. 2. The specific changes made in response to

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<sup>3</sup> 72 FR 10533 (March 8, 2007).

<sup>4</sup> See [www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/FederalAgencyGuidanceDatabase/State\\_Implementation.htm](http://www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/FederalAgencyGuidanceDatabase/State_Implementation.htm).

these comments are detailed below. The Agencies opted not to include additional text in the illustrations that would discuss the benefits of nontraditional mortgage products, to ensure that the materials focus on an objective description of material terms, risks, and features of such products. Institutions are not precluded, of course, from providing factual information concerning the features of their products to consumers.

One commenter asked whether the consumer information brochure entitled “Interest-Only Mortgage Payments and Payment-Option ARMs–Are They for You?” could be used in place of the illustrations to provide information to consumers. The information contemplated by the Interagency NTM Guidance serve a different purpose than this brochure. This detailed, multi-page publication includes valuable in-depth information, but it does not represent the more concise and focused consumer information contemplated by, and recommended in, the Interagency NTM Guidance. Illustrations 1 and 2, by contrast, are designed to be concise and focused so they can be quickly referenced by consumers during the mortgage shopping process. While, as explained in detail above, institutions are not required to use the illustrations, and may elect to provide the information contemplated in the Interagency NTM Guidance in a modified or alternate format, delivering this more detailed publication to consumers would not serve this same purpose or provide the information as recommended in the guidance.

The Agencies’ changes to each Proposed Illustration are discussed below.

#### **A. Proposed Illustration No. 1**

Although most commenters stated that Illustration No. 1 would be useful in helping consumers understand the risks of nontraditional mortgage products, several suggested that the Agencies make the illustration more user-friendly by using simpler language and larger fonts. Most trade organization and financial institution commenters generally agreed that Illustration

No. 1 would be helpful. Consumer groups, on the other hand, expressed their desire that the illustrations strongly communicate the risks of nontraditional mortgage products and add language clarifying that making the minimum payments on a payment option mortgage could lead to a reduction in a borrower's equity. Several consumer groups recommended that the illustration not suggest that consumers should request information orally from a lender, because consumers should be encouraged to review written information rather than rely on oral representations.

To address the commenters' concerns, the Agencies have simplified Illustration No. 1, deleted text where possible to shorten the length of the illustration, and made formatting changes to improve readability. Additionally, the Agencies have included language clarifying that making the minimum payments on a payment option mortgage could lead to a reduction in a borrower's equity. The Agencies have also added language advising consumers that if they do not understand the terms of a particular loan, they should not sign any loan contracts, and may want to consider other types of loans.

#### **B. Proposed Illustration No. 2**

Many commenters found proposed Illustration No. 2 confusing. Specifically, several commenters said the footnotes and the explanation of the minimum monthly payment row for years one through five of a payment option ARM would confuse consumers. A few commenters suggested that Illustration No. 2 would be most helpful to consumers if a loan officer or credit counselor reviewed it with them. Additionally, one financial institution suggested that Illustration No. 2 should emphasize the risks of payment shock and negative amortization.

One industry trade group stated that assuming borrowers make minimum payments is unrealistic. This commenter added that the interest rates in the examples should represent a

typical interest rate environment in which a fixed rate loan would have a higher rate than an adjustable rate loan. However, one financial institution suggested that the illustration should use the same interest rates for all the products to make comparison easier. One trade group stated that the rates for interest-only and payment option ARM loans should be higher to reflect the terms offered to non-prime borrowers. Two commenters stated that the illustration should use a \$100,000 loan amount that would be easier for consumers to compare to their loan amounts than the \$180,000 amount used in the proposed illustration.

A few commenters warned against using any assumptions that could become dated. Instead, one industry group suggested that payment amounts and interest rate information in Illustration No. 2 should be left blank so that loan officers and consumers could fill out the numbers themselves as they discuss and consider loan options. Another commenter suggested that the Agencies create a Web site where consumers could input their own specific information into different mortgage structures and get accurate and easy-to-understand cost alternatives.

To address commenter concerns, and to maintain consistency with the Interagency NTM Guidance, the Agencies have simplified Illustration No. 2 by reducing the number of products for which information is provided. The simplified illustration eliminates the need for footnotes or similar explanations. Additionally, the Agencies made formatting changes to draw consumers' attention to the important points the chart seeks to illustrate.

The Agencies agreed with commenters that a sample loan amount of \$180,000 could make it more difficult for consumers to estimate their own payment amounts. The Agencies, therefore, have adopted a representative loan amount of \$200,000, which is closer to the national median price for a single family home than the \$100,000 loan amount suggested by some commenters.

### **C. Proposed Illustration No. 3**

The Agencies received the fewest specific comments on Illustration No. 3. Moreover, commenters did not express concern that consumers would have difficulty understanding Illustration No. 3. Several commenters, however, asked the Agencies to make clear that lenders will have flexibility with regard to how and when to provide the information contemplated by the third illustration. One trade group stated that the third illustration could be burdensome for lenders that do not provide monthly statements. Similarly, another trade group asked the Agencies to state that lenders could provide the third illustration less frequently than monthly, or through an explanation on the lender's Web site. In contrast, another trade group stated that the Agencies should encourage lenders to provide monthly statements.

One financial institution recommended that the illustration include the resulting loan balance with each payment choice so that the consumer can see how their choice affects the loan on a monthly basis. However, one financial institution and one trade group commenter stated that providing specific payment information would be burdensome and that lenders would require implementation time to make system changes.

After reviewing and considering the comments, the Agencies decided not to make substantial changes to Illustration No. 3. The Interagency NTM Guidance recommends that *if* institutions provide monthly statements to consumers on payment option mortgages, those monthly statements should provide information that enables consumers to make informed payment choices, including an explanation of each payment option available and the impact of that choice on loan balances. Illustration No. 3 shows one way in which this information could be presented. Financial institutions retain the flexibility to provide the information in a format best suited to their customer's needs. Moreover, it is important to note this illustration is not

intended to set forth all of the information lenders could provide that may be useful, such as the current loan balance, an itemization of the payment amount devoted to interest and to principal, and whether the loan balance has increased.

The final illustrations appear below.

## Illustration 1

### **Important Facts About Interest-Only and Payment Option Mortgages**

Whether you are buying a house or refinancing your mortgage, this information can help you decide if an interest-only mortgage or a payment option mortgage is right for you. These mortgages can be complicated. If you do not understand how they work, you should not sign any loan contracts, and you might want to consider other types of loans.

**Interest-Only Mortgages** allow you to pay only the interest on the money you borrowed for the first few years of the mortgage (the “interest-only period”).

**If you pay only the amount due, then at the end of the interest-only period:**

- You will still owe the original amount you borrowed.
- Your monthly payment will increase because you must pay back the principal as well as interest. Your payment could increase even more if you have an adjustable rate mortgage (“ARM”) and interest rates increase.

**Payment Option Mortgages** allow you to choose among several payment options each month during the first few years of the loan (the “option period”). The option period will end earlier than scheduled if the amount you owe grows beyond a set limit—for example, 110% or 125% of your original mortgage amount.

**During the option period, the payment options usually include:**

- A payment of principal and interest, which reduces the amount you owe over time.
- An interest-only payment, which does not reduce the amount you owe.
- A minimum payment, which may be less than the interest due that month. *If you choose this option, any unpaid interest will increase the amount you owe.*

**At the end of the option period, depending on what payment options you chose:**

- You could owe substantially more than the original amount you borrowed.
- Your monthly payment could increase significantly because:
  - You may have to start paying back principal, as well as interest.
  - Unpaid interest may have increased the amount you owe.
  - Interest rates may have increased (if you have an ARM).

### **Additional Information**

► **Home Equity**—If you make interest-only payments, your payments are not building home equity. And, if you make only the minimum payment on a payment option mortgage, you may be losing home equity. This may make it harder to refinance your mortgage or to obtain funds from selling or refinancing your home.

► **Prepayment Penalties**—Some mortgages require you to pay a lump-sum prepayment penalty if you sell your home or refinance during the first few years of the loan. You should find out if your mortgage has a prepayment penalty, how it works, and how much it could be.

► **No Doc/Low Doc Loans**—“Reduced documentation” or “stated income” loans usually have higher interest rates or other costs compared to “full documentation” loans that require you to verify your income and assets.



Illustration 2

**SAMPLE MORTGAGE COMPARISON**

*(Not actual loans available)*

**Sample Loan Amount \$200,000 – 30-Year Term – Interest Rates For Example Purposes Only**

	<b>Traditional Fixed Rate Mortgage</b> (7%)	<b>5-Year Interest-Only ARM</b> (initial rate 7%; maximum rate 12%)	<b>Payment Option ARM</b> (rate in 1 <sup>st</sup> month 2%; variable rate after 1 <sup>st</sup> month (starting at 7%); maximum rate 12%)
<b>REQUIRED MONTHLY PAYMENTS</b>			
<b>Years 1-5</b>	<b>\$1,331</b>	<b>\$1,167</b>	<b>\$739–\$987</b> (increasing annually)
<b>Year 6 – if rates don't change</b>	<b>\$1,331</b>	<b>\$1,414</b>	<b>\$1,565</b>
<b>Year 6 – if rates rise 2%</b>	<b>\$1,331</b>	<b>\$1,678</b>	<b>\$1,859</b>
<b>Year 8 – if rates rise 5%</b>	<b>\$1,331</b>	<b>\$2,094</b>	<b>\$2,319</b>
<b>EFFECT ON LOAN BALANCE AND HOME EQUITY</b>			
<b>After 5 Years, How Much Will You Owe?</b>	<b>\$188,263</b>	<b>\$200,000</b>	<b>\$221,486</b>
<b>After 5 Years, How Much Home Equity Have Your Loan Payments Built?</b>	<b>\$11,737</b>	<b>\$0</b>	<b>NEGATIVE \$21,486</b>

Illustration 3

Your Payment Options This Month	Amount	Impact
<b>Principal and Interest Payment</b>	\$_____	<ul style="list-style-type: none"><li>• You will pay some of the principal on your loan.</li><li>• You will reduce your loan balance.</li></ul>
<b>Interest-Only Payment</b>	\$_____	<ul style="list-style-type: none"><li>• You will not pay any principal on your loan.</li><li>• You will <b>not</b> reduce your loan balance.</li></ul>
<b>Minimum Payment</b>	\$_____	<ul style="list-style-type: none"><li>• You [will] [will <b>not</b>] cover the interest on your loan.</li><li>• You [will not] [will] <b>increase</b> your loan balance.</li></ul>

[THIS SIGNATURE PAGE RELATES TO THE FINAL GUIDANCE TITLED  
“ILLUSTRATIONS OF CONSUMER INFORMATION FOR NONTRADITIONAL  
MORTGAGE PRODUCTS”]

Dated:

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John C. Dugan,  
Comptroller of the Currency

[THIS SIGNATURE PAGE RELATES TO THE FINAL GUIDANCE TITLED  
“ILLUSTRATIONS OF CONSUMER INFORMATION FOR NONTRADITIONAL  
MORTGAGE PRODUCTS”]

By order of the Board of Governors of the Federal Reserve System, [DATE]

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Jennifer J. Johnson  
Secretary of the Board

[THIS SIGNATURE PAGE RELATES TO THE FINAL GUIDANCE TITLED  
“ILLUSTRATIONS OF CONSUMER INFORMATION FOR NONTRADITIONAL  
MORTGAGE PRODUCTS”]

Dated at Washington, D.C., the \_\_\_\_ day of \_\_\_\_\_, 2007

By order of the Federal Deposit Insurance Corporation

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Robert E. Feldman,  
Executive Secretary

[THIS SIGNATURE PAGE RELATES TO THE FINAL GUIDANCE TITLED  
“ILLUSTRATIONS OF CONSUMER INFORMATION FOR NONTRADITIONAL  
MORTGAGE PRODUCTS”]

Dated: [\_\_\_\_\_]
By the Office of Thrift Supervision

John Reich,
Director

[THIS SIGNATURE PAGE RELATES TO THE FINAL GUIDANCE TITLED  
“ILLUSTRATIONS OF CONSUMER INFORMATION FOR NONTRADITIONAL  
MORTGAGE PRODUCTS”]

Dated: [\_\_\_\_\_]   
By the National Credit Union Administration

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JoAnn M. Johnson,  
Chairman

# NCUA LETTER TO CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION  
1775 Duke Street, Alexandria, VA 22314

DATE: April 2007 LETTER NO.: 07-CU-06

TO: Federally Insured Credit Unions

SUBJ: Working with Residential Mortgage Borrowers

ENCL: [Statement on Working With Mortgage Borrowers](#)

REF: [Letter to Credit Unions #05-CU-15, Increasing Risks in Mortgage Lending](#)

Dear Board of Directors,

In 2005, the National Credit Union Administration (NCUA) discussed increasing risks to mortgage borrowers in Letter to Credit Unions 05-CU-15, *Increasing Risks in Mortgage Lending*. As discussed in that letter, some residential mortgage borrowers are experiencing mortgage repayment difficulties or "payment shock," as the interest rates on their mortgages reprice or reset. Some of these borrowers may not have the ability to repay substantially higher payments since they were qualified based on low initial interest rates.

NCUA recently joined other federal regulators in issuing a statement encouraging financial institutions to work constructively with residential mortgage borrowers who may be unable to meet their contractual payment obligations. A copy of the joint statement is attached to this letter. Federally insured credit unions are reminded that prudent workout arrangements can be in the long-term best interest of both credit unions and their members. NCUA encourages credit unions to consider reasonable workout agreements, whenever sound, that allow members to keep their homes.

Sincerely,

/s/

JoAnn Johnson  
Chairman

[Enclosure](#)



## **Statement on Working with Mortgage Borrowers**

The federal financial institutions regulatory agencies<sup>1</sup> encourage financial institutions to work constructively with residential borrowers who are financially unable to make their contractual payment obligations on their home loans. Prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower.

Many residential borrowers may face significant payment increases when their adjustable rate mortgage (ARM) loans reset in the coming months. These borrowers may not have sufficient financial capacity to service a higher debt load, especially if they were qualified based on a low introductory payment. The agencies have long encouraged borrowers who are unable to meet their contractual obligations to contact their lender or servicer to discuss possible payment alternatives at the earliest indication of such problems.

The agencies encourage financial institutions to consider prudent workout arrangements that increase the potential for financially stressed residential borrowers to keep their homes. However, there may be instances when workout arrangements are not economically feasible or appropriate.

Financial institutions should follow prudent underwriting practices in determining whether to consider a workout arrangement. Such arrangements can vary widely based on the borrower's financial capacity. For example, an institution might consider modifying loan terms, including converting loans with variable rates into fixed-rate products to provide financially stressed borrowers with predictable payment requirements.

The agencies will continue to examine and supervise financial institutions according to existing standards. The agencies will not penalize financial institutions that pursue reasonable workout arrangements with borrowers who have encountered financial problems. Further, existing supervisory guidance and applicable accounting standards do not require institutions to immediately foreclose on the collateral underlying a loan when the borrower exhibits repayment difficulties. Institutions should identify and report credit risk, maintain an adequate allowance for loan losses, and recognize credit losses in a timely manner.

Financial institutions may receive favorable Community Reinvestment Act (CRA) consideration for programs that transition low and moderate income borrowers from higher cost loans to lower cost loans, provided the loans are made in a safe and sound manner.<sup>2</sup> Financial institutions, working alone or in conjunction with reputable organizations such as the Center for Foreclosure Solutions sponsored by NeighborWorks, can assist borrowers in avoiding foreclosure through credit counseling.<sup>3</sup> Such programs also help financially stressed borrowers avoid predatory foreclosure rescue scams.

Under the Homeownership Counseling Act, financial institutions should inform certain borrowers who are delinquent on their mortgage loans (home loans secured by a single family dwelling that is the borrower's principal residence) about the availability of homeownership counseling. The Department of Housing and Urban Development (HUD) maintains a list of approved counselors.<sup>4</sup>

If a service member defaults on a mortgage, the Servicemembers Civil Relief Act (SCRA) prohibits the sale, foreclosure, or seizure of service member property secured by the mortgage during the period of military service, or within 90 days thereafter. Institutions are required to notify service members of their rights under the SCRA.<sup>5</sup> While the SCRA requirements apply only to obligations that were originated prior to the service member's military service, the agencies encourage institutions to work with service members and their families who are unable to meet any of their contractual mortgage obligations.

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<sup>1</sup> The federal financial institutions regulatory agencies consist of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision (collectively, the agencies).

<sup>2</sup> Consideration as a CRA flexible lending practice may be granted in instances where such action helps to meet the credit needs of low- and moderate-income individuals or geographies within the institution's assessment area, and is consistent with safe and sound lending practices. Also see Q&A § \_\_.22(a)– 1 (2001 Interagency Questions and Answers Regarding Community Reinvestment). Federal credit unions are not subject to CRA requirements.

<sup>3</sup> Consideration as a CRA community development service may be granted in instances where such activities help to meet the credit needs of low- and moderate-income individuals or geographies within the institution's assessment area. Also see Q&A § \_\_.12(j)– 3 (2001 Interagency Questions and Answers Regarding Community Reinvestment). Federal credit unions are not subject to CRA requirements.

<sup>4</sup> Information on HUD's counseling services is available at <http://www.hud.gov/offices/hsg/sfh/hcc/hcs.cfm> or (800) 569-4287.

<sup>5</sup> HUD's service member notice is available at <http://www.hud.gov/offices/adm/hudclips/forms/files/92070.pdf>.

# **NCUA LETTER TO FEDERAL CREDIT UNIONS**

**NATIONAL CREDIT UNION ADMINISTRATION  
1775 Duke Street, Alexandria, VA 22314**

**DATE:** August 2006 **LETTER NO.:** 06-FCU-04  
**TO:** Federal Credit Unions  
**SUBJ:** Evaluation of Earnings  
**ENCL:** Supervisory Letter – Evaluation of Earnings

Dear Board of Directors:

The purpose of this Letter is to provide all Federal Credit Unions with the same guidance provided to NCUA field staff about evaluating earnings. The attached Supervisory Letter was provided to NCUA field staff in August 2006.

NCUA appreciates the delicate balance credit unions must strive to achieve between the short-term and long-term needs of the credit union. In this regard, I encourage credit union officials to be committed to a sincere, conscientious, and well-planned strategy to safely balance the net worth and earnings needs of the credit union with strategies to achieve longer-term objectives. I am confident that with an open dialogue examiners will be supportive of such endeavors.

However, in the event any disagreements with your examiner in this respect cannot be resolved, please contact your supervisory examiner or regional office. For any such disagreements with an NCUA regional office, please contact NCUA's Supervisory Review Committee.<sup>1</sup>

Sincerely,

/s/

JoAnn M. Johnson  
Chairman

Enclosure

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<sup>1</sup> Refer to [www.ncua.gov/RegulationsOpinionsLaws/IRPS/1995/IRPS95-1.html](http://www.ncua.gov/RegulationsOpinionsLaws/IRPS/1995/IRPS95-1.html) and [www.ncua.gov/RegulationsOpinionsLaws/IRPS/2002/IRPS02-1.html](http://www.ncua.gov/RegulationsOpinionsLaws/IRPS/2002/IRPS02-1.html) for information on submitting appeals to NCUA's Supervisory Review Committee.

# SUPERVISORY LETTER

NATIONAL CREDIT UNION ADMINISTRATION  
OFFICE OF EXAMINATION AND INSURANCE  
1775 DUKE STREET, ALEXANDRIA, VA 22314

**DATE:** August 2006

**Supervisory Letter No.:** 06-01

**TO:** All Field Staff

**SUBJECT:** Evaluating Earnings

The determination of an adequate earnings level is a complex facet of credit union supervision. Lower earnings are being observed nation-wide. This trend is the result of rising interest rates, a flat yield curve, and some credit unions incurring costs to position themselves strategically. There is no simple metric for determining what a credit union's retained earnings level should be. However, as emphasized in NCUA Letter to Credit Unions 03-CU-04 (March 2003), *CAMEL Rating System*, CAMEL ratings are not automatically determined by matrix ratios. Striving for an arbitrary one percent Return on Average Assets just to achieve a CAMEL 1 rating based on the CAMEL matrix is not an acceptable argument, especially in the current economy, for a well capitalized credit union. Each credit union's earnings level must be evaluated relative to net worth needs, financial and operational risk exposures, the current economic climate, and the institution's strategic plans.

Net worth goals involve both immediate considerations, as well as strategic ones related to future risks and expansion plans. The officials have to balance the immediate return of earnings to the members in various forms (e.g., dividends, lower loan rates, etc.) with the retention of earnings to fund future member benefits. Thus, NCUA must take a balanced approach to assessing earnings. We must be careful not to inadvertently undermine a credit union's ability to achieve long-term success with an unduly conservative or short-term focused approach to supervision. An overly simplistic focus on one measure of earnings performance could drive unsafe and unsound behavior. In fact, attempting to bolster earnings in the current environment is very likely to involve strategies that necessitate excessive risk-taking.

If you have any questions on this issue, please direct them to your immediate supervisor or regional management.

Sincerely,

/s/

David M. Marquis,  
Director, Office of Examination and Insurance



# Supervisory Letter



## Evaluating Earnings in Credit Unions

### Credit Unions are Not-For-Profit

Credit unions are not-for-profit cooperative financial institutions. Groups of people sharing a common bond form credit unions to pool their resources to provide access to affordable financial services designed to meet their needs. As a cooperative not-for-profit organization, a credit union's mission is to provide financial services to their members, not to earn a profit for stockholders. Any economic value generated by the credit union that is undistributed (i.e., not used to absorb costs or provide an immediate return to the members) is held on behalf of and owned by the members.

Though not-for-profit, credit unions must generate revenue for two primary reasons: (1) to cover the costs of providing members with financial services, and (2) to maintain a safe and sound level of net worth. Net worth is necessary to provide protection against unexpected future costs and a foundation for member service growth and initiatives, as well as to meet regulatory capital standards. In order to build and maintain appropriate net worth levels, credit unions must retain earnings (i.e., have a net income sometimes referred to as a "profit").<sup>1</sup>

NCUA's mission statement is *"to foster the safety and soundness of federally insured credit unions and better enable the credit union community to extend financial services for provident and productive purposes to all who seek such service while recognizing and encouraging credit unions' historical emphasis on extension of financial services to those of modest means..."* This mission statement highlights a balance that both NCUA and credit unions must strive to maintain: balancing safety and soundness with the mission of extending financial services. Perhaps the most notable way this challenge manifests itself is in determining the "right" level of net worth.

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<sup>1</sup> Other financial institutions have the ability to utilize forms of equity other than retained earnings. Except for low-income designated credit unions authorized to employ secondary capital instruments, credit unions manage net worth levels exclusively via retained earnings. The standard measurement for net income for credit unions is the Return on Average Assets ratio (ROA).

Net worth is essential to credit unions. Not only does it protect against uncertainties, but also provides a foundation for the long-term viability of the credit union, ensuring continued credit union service for current and subsequent generations of members. When net worth is too low, an institution is exposed to a high risk of failure. On the other hand, when net worth is too high members may not be receiving all the benefits and services that could be safely provided and/or the credit union may not be taking advantage of opportunities to position itself to expand member benefits in the future. Despite a natural tendency to err on the side of conservatism, NCUA's supervisory oversight must support credit unions' efforts to balance net worth needs with providing value and achieving longer-term strategic goals.<sup>2</sup>

## Earnings Assessment Framework

As the purpose of retaining earnings for credit unions is to build or maintain net worth, the analysis of earnings is fundamentally linked with the net worth needs of the credit union. This is reflected in NCUA's CAMEL rating system (Letter 03-CU-04, CAMEL Rating System) which lists the net worth level and sufficiency of earnings for necessary capital formation as key factors to consider when assessing earnings. In fact, earnings needs in credit unions are a function of the net worth ratio goal, which in turn is affected by asset growth levels.<sup>3</sup> Thus, retained earnings goals set independently, as if net income is an aspect of a credit union's financial performance that has merit in and of itself, run the risk of being incompatible with other organizational goals.

Further, there is distinct time dimension to any analysis of earnings. This is due to the following:

- Net worth goals involve both immediate considerations, as well as strategic ones related to future risks and growth and member service expansion plans. The officials have to balance the immediate return of earnings to the members in various forms (e.g., dividends, lower loan rates, etc.) with the retention of earnings to fund future member benefits.
- Variations over time in economic conditions affecting a credit union's cost structure and rates on loan and share products.

*"Examiners evaluate "core" earnings: that is the long-run earnings ability of a credit union discounting fluctuations in income and one-time items." – Letter 03-CU-04, CAMEL Rating System*

<sup>2</sup> The issue of capital adequacy is explored in more detail in Supervisory Letter 05-01, Examiner Guidance – Evaluating Capital Adequacy.

<sup>3</sup> The Net Worth Ratio (NWR), the standard measurement for net worth levels in credit unions, is calculated by dividing net worth by total assets. Mathematically, the NWR is affected by both changes in net worth (numerator), which are caused by net income (loss) levels, and by asset growth (denominator), which is predominantly driven by share growth.

There is no simple metric for determining what an individual credit union's ROA level should be. A 1-percent ROA level has served as the "rule-of-thumb" for good performance for financial institutions for some time. The establishment of the CAMEL matrix in 1987 canonized for credit unions a 1-percent ROA by tying it to a CAMEL 1 component rating for Earnings.<sup>4</sup> However, as emphasized in NCUA Letter to Credit Unions 03-CU-04 (March 2003), CAMEL Rating System, CAMEL ratings are not automatically determined by matrix ratios. Each credit union's earnings level must be evaluated based on the credit union's unique needs, as well as overall economic trends affecting financial institutions.

*"Fixation on a profitability target established in a vacuum (e.g. striving for a 1% ROA for the sake of meeting this rule-of-thumb) often leads to poor decision-making with negative long-term consequences for the institution." - Supervisory Letter 05-01, Evaluating Capital Adequacy*

For example, consider contemporary economic trends. In 2005, aggregate credit union ROA dropped to 85 basis points, the lowest level in at least 20 years. Interest rates have been rising steadily since mid-2004, with the Federal Reserve raising interest rates for the 17<sup>th</sup> consecutive time. As a result, the net interest margin declined to 3.24 percent, its lowest level in at least 20 years. The low net interest margin, and thus reduced ROA, is a direct result of both a rising rate environment and a flat yield curve.<sup>5</sup> Credit unions partially offset the pressure on earnings with increased fee and other income, with this source of income playing an increasingly larger role.

Ratio (% Average Assets)	As of 2000	As of 2005	Effect on ROA
<b>Net Interest Margin</b>	3.77%	3.24%	- 53bp
<b>+ Fee &amp; Other Income</b>	0.94%	1.22%	+ 28bp
<b>- Operating Expenses</b>	3.39%	3.24%	+ 15bp
<b>- PLLL</b>	0.32%	0.40%	- 8bp
<b>+ Non-Operating Income</b>	0.01%	0.03%	+ 2bp
<b>= ROA</b>	1.01%	0.85%	- 16bp

However, credit unions' aggregate net worth ratio is at record levels and actually increased 30 basis points to 11.24 percent. Despite a decline in ROA, net worth growth of 7.59 percent outpaced the modest asset growth of 4.90 percent. Consistent with the purpose of net worth, credit unions are well positioned with ample net worth levels to accept lower ROA levels during the current economic climate that has resulted in reduced net interest margins. Consider that, on average, the modest asset growth levels credit unions have experienced over the last 10 years require an ROA of only 55 basis points to maintain net worth levels at their current strong level.<sup>6</sup>

<sup>4</sup> The 1% ROA rule-of-thumb has been tenacious, still serving under the current CAMEL guidance as the benchmark for a CAMEL 1, despite the CAMEL rating system having undergone several revisions since its adoption in 1987 for credit unions.

<sup>5</sup> Given the maturity and repricing differences between assets and liabilities, financial institutions experience reduced earnings when short-term rates rise or when the difference between short-term rates and long-term rates declines.

<sup>6</sup> Over the last 10 years, which includes the extraordinary growth levels experienced in 2001 and 2002 due to the weak stock market performance and post-9/11 flight to safety, the median and mean levels of annual asset growth for credit unions have been 4.53% and 5.33% respectively. Mathematically, a credit union with an 11% net worth ratio and asset growth of 5% only needs an ROA of 55 basis points to maintain the net worth ratio.

Thus, credit unions need not engage in reactive or extraordinary measures simply because earnings levels decline as a result of broader economic conditions when net worth levels meet or exceed their needs. In fact, such measures likely involve significant risks, either in terms of accepting greater risks to generate higher returns, and/or in terms of short-sighted trade-offs (e.g., increasing fees, selling “less profitable” business lines, engaging in high risk lending) affecting the longer-term strategic positioning of the credit union.

## Examiner Assessment of Earnings

Examiners do not evaluate earnings globally with peer ratios or CAMEL benchmarks; earnings are evaluated on a case-by-case basis unique to each credit union’s circumstances.<sup>7</sup> An examiner’s review of earnings is in relation to each credit union’s risk profile, operational context, and strategic plans.

The ROA level is not the primary focus of an examiner’s assessment of earnings. Historical earnings levels are somewhat relevant to assessing management’s record in managing earnings. However, it is quite possible for a credit union to have impressive profitability ratios by assuming an unacceptable degree of risk. Thus, examiners assess management’s capability in managing the risk versus reward trade-off, evaluating earnings by considering the:

*“No analysis of profitability is complete without considering the quality of earnings by gaining a thorough understanding of the strategies employed by management to achieve the level of profitability. For example, it is possible for a credit union to record strong profitability levels in the short-term by assuming an unacceptable degree of credit or interest rate risk.” – Supervisory Letter 05-01, Evaluating Capital Adequacy*

- Quality of the earnings structure.
- Fit with the overall strategies of the credit union.
- Future direction of earnings performance.
- Ability of the credit union to realize an adequate level of earnings in a safe and sound manner.

Lower ROA levels will be viewed positively if they are the result of a sound and well-executed strategy to balance risk exposure or incur costs to position the credit union to achieve longer-term growth and member service objectives. In addition, examiners recognize that the purpose for credit unions retaining earnings is maintaining appropriate, but not excessive, net worth levels relative to the risk profile of the credit union. In fact, executing a sound plan to return excess capital to the membership or utilize capital to achieve longer-term strategic objectives can contribute greatly to the long-term success of the credit union. Examiners also positively incorporate such strategies into their evaluation of earnings and capital.

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<sup>7</sup> Certainly there is value in NCUA and the credit union community reviewing performance ratios on a global basis to understand trends in the industry; however, this does not mean all credit unions should be operating at the same levels.



## Earnings Red Flags

Examiners need to evaluate the level of earnings in relation to the credit union's risk profile and the current economic environment. Below are examples of red flags that trigger a more in-depth review of a credit union's earnings performance. Note that inordinately high earnings levels can be just as much a sign of a problem as low earnings levels.

*"Keystone Bank appeared to be the nation's most profitable community bank for the three years prior to and including the year it failed. The loss to the insurance fund is estimated at \$750 million. The American Banker reported that in 1995, BestBank was 'the best performer among U.S. banks.' The bank failed in 1998 with a projected loss of \$223 million to the insurance fund." – FDIC Symposium Why Do Banks Fail?*

Inordinately high net income could indicate:

- ☑ Taking on additional risk in the investment or loan portfolio.
- ☑ Not providing competitive dividend or loan rates.
- ☑ Not providing adequate services for the membership.
- ☑ Not planning for new services or infrastructure to support the credit union in the future.
- ☑ Undue reliance on fee income to support operations.
- ☑ Management or board goals for high net income levels given ties (implicit or explicit) to bonuses, salaries, or performance evaluations.
- ☑ Management believes their examiner will not tolerate or accept lower earnings and/or net worth, even with a solid plan.

Inordinately low net income could indicate:

- ☑ Inefficient operations resulting in high or out of control expenses to the detriment of the membership. Examiners will continue to address high operating expenses as a problem area if they do not involve an intentional increase in the credit union's investment in infrastructure (technology, new services, increased training, etc.) as part of a documented, sound strategic plan.
- ☑ Exorbitant compensation systems misaligned with member benefits and the mission of the credit union.
- ☑ Inadequate pre-planning for new services.
- ☑ High level of non-earning assets not aligned with the strategic needs of the credit union.
- ☑ Economic disruption impacting the field of membership.
- ☑ Unsafe dividend levels attracting volatile share growth.
- ☑ High loan losses due to poor credit quality loans.

The fact that a credit union's net income level is relatively high or low is not by itself evidence there is a problem. Rather, it is merely a trigger for examiners to thoroughly review the credit union's earnings structure to determine the underlying factors that result in the performance. Examiners assess these factors in relation to the credit union's overall condition, consistency with the mission of the credit union, and congruence with the credit union's strategic plans and budgets.

## Conclusion

Earnings is one of the five component ratings, contributing to the overall composite rating, examiners assign under the CAMEL rating system.<sup>8</sup> Further, the quality of the credit union's earnings structure and underlying strategies is one of the key considerations in assignment of risk ratings in the seven areas of risk under the risk-focused examination program.<sup>9</sup> The determination of the

CAMEL composite and component ratings, as well as the risk ratings in the seven areas of risk, is a judgmental process and necessitates the examiner take into account all of the subjective and objective variables that affect a credit union's financial and operational condition, as well as their interrelationships. The key interrelationship examiners take into consideration for the Earnings CAMEL component rating is the net worth needs of the credit union.

It is incumbent on credit unions to proactively develop and document sound strategic plans. These plans need to articulate the balance the officials of the credit union are seeking in terms of net worth levels and the actions affecting earnings to achieve the mission of the credit union in both the short and long-term. In the absence of documented and sound plans, attempting to justify poor earnings performance after the fact is considered not only a weakness in the Earnings component of CAMEL, but the Management component and relevant risk ratings in the seven areas of risk as well.

Given their not-for-profit nature, an analysis of Earnings in credit unions is admittedly challenging. It requires factoring in the role earnings plays in credit unions fulfilling their mission of providing *financial services for provident and productive purposes to all who seek such service*. The elected officials seek to balance the return of current earnings to the members with retaining earnings to provide an adequate "safety net" and a base for better, lower-cost, and expanded services in the future. These, along with a variety of other factors such as the contemporary decisions affecting the direction of the risk in a credit union's balance sheet, require examiners to exercise a high degree of professional judgment when evaluating earnings.

Thus, it is essential credit union management and examiners have an open and ongoing dialogue on the strategic direction of the credit union in relation to earnings. Credit union officials and examiners should welcome any sincere debates that occur on the efficacy of a credit union's plans. A healthy dialogue will help ensure credit unions are able to fine-tune and execute their strategies effectively as well as enable NCUA to balance our mandates of protecting the share insurance fund with supporting credit unions in fulfilling their mission.

*"The CAMEL rating is not automatically determined by matrix ratios alone. The matrix ratios for the capital, asset quality, and earnings components provide minimal guidance for the examiner's final assessment of the individual component rating...When evaluating the CAMEL components, examiners will consider both the quantitative and qualitative considerations outlined in the Enclosure before a final rating is determined."* - Letter 03-CU-04, CAMEL Rating System

<sup>8</sup> Capital Adequacy, Asset Quality, Management, Earnings, and Liquidity Management.

<sup>9</sup> The seven areas of risk are credit, interest rate, liquidity, transaction, compliance, strategic, and reputation.

## References

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